Rethinking the Line Between Corporate Law and Corporate Bankruptcy

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I. Introduction

In the past two years, bankruptcy theory has taken on an almost apocalyptic tone as scholars debate whether the corporate reorganization provisions set forth in Chapter 11 of the current Bankruptcy Code should be dramatically altered or even abolished.[1] One by one, almost everyone who has contributed to the bankruptcy literature in recent years seems to have weighed in on the issue of what should be done with Chapter 11.[2]

In the midst of the academic fervor, Congress has been considering legislation that would effect the most significant changes in bankruptcy law since the enactment of the current Bankruptcy Code in 1978.[3] As frequently is the case, the proposed legislation falls far short of the complete transformation of corporate reorganization that has been advocated in some of the academic literature. And yet, the proposed legislation would establish a bankruptcy commission charged with conducting a full investigation of the current bankruptcy regime.[4] The calls for the abolition of Chapter 11 have received so much attention, both in law reviews and in the popular media,[5] that we can be sure that the advocates of this step would, at the very least, have their say before the commission.

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1. A recent article drew public attention to the debate about Chapter 11. *See* Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1079 (1992) (questioning the efficiency of Chapter 11 based on an empirical analysis and proposing "contingent equity" as an alternative). Other important articles in recent literature include: Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 312 (1993) (arguing that bankruptcy law could be replaced by contractual alternatives and proposing a "Chameleon Equity" regime); Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633 (1993) (discussing the likely costs and benefits of a mandatory auction regime); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992) (arguing that investors should be allowed to select from a menu of bankruptcy options at the time a corporation is formed); and Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. & ECON. 595 (1993) (arguing that the costs involved in protracted bankruptcy proceedings could be avoided by private workout offer clauses in contracts). For a survey and extensive critical analysis of these current proposals, see David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465.

2. Many of these articles have commented critically on Bradley & Rosenzweig's proposal. *See* Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV. 79 (1992); Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992); *see also* Theodore Eisenberg & Shoichi Tagashira, Should We Abolish Chapter 11? The Evidence from Japan (Mar. 30, 1993) (unpublished manuscript, on file with the *Texas Law Review*) (suggesting that we should rethink proposals to abolish or reform Chapter 11). James Bowers has recently challenged LoPucki's and Warren's critiques of Bradley & Rosenzweig. *See* James W. Bowers, *The Fantastic Wisconsylvania Zero-Bureaucratic-Cost School of Bankruptcy Theory: A Comment*, 91 MICH. L. REV. 1773 (1993).

3. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101-1330 (1988)) [hereinafter Bankruptcy Reform Act of 1978]. The bankruptcy legislation considered by Congress in 1992, *see* S. 1985, 102d Cong., 1st Sess. (1991), ultimately died in the House. For a brief overview and chronology of this legislation, see David F. Bantleon & Kathy L. Kresch, *A Bankruptcy Law for the '90s*, BUS. L. TODAY, Jan.-Feb. 1993, at 25. After reintroduction in 1993, the legislation has suffered a similar fate under almost the same circumstances. *See* S. 540, 103d Cong., 1st Sess. (1993).

4. S. 540, 103d Cong., 1st Sess. §§ 402-403 (1993).

5. *See, e.g.*, Peter Passell, *Critics of Bankruptcy Law See Inefficiency and Waste*, N.Y. TIMES, Apr. 12, 1993, at A1. For examples of some of the earlier articles in the popular media, see Skeel, *supra* note 1, at 472 n.23.

All of the excited debate in academic circles and in Congress has focused on a single question: *What* should be done with the current corporate reorganization regime? To date, no one has asked the equally, and perhaps even more, important question of *who*—that is, what political institution—should be deciding which changes should or should not be made.

The absence of discussion concerning who should regulate corporate bankruptcy is somewhat surprising for at least two reasons. First, for twenty years corporate law scholars have been debating whether some or all of corporate law should be federalized (or, on the other hand, whether Congress should relinquish control over those areas, such as securities law, that it already regulates).[6] Given that corporate bankruptcy is an extension of general corporation law, the question of whether Congress or the states should regulate corporate bankruptcy would seem to be an obvious corollary to the charter competition debate among corporate law scholars.

Second, whether Congress or the states are the appropriate decisionmakers has been a particularly important question as a historical matter. In the mid-nineteenth century, the controversy concerning control of corporate bankruptcy became the single most pressing issue under discussion as lawmakers considered proposed legislation that eventually became the Bankruptcy Act of 1841. Only at the end of the century did the debate finally begin to fade.

The principal theme of this Article is that it is time to reopen the debate as to whether Congress or the states should regulate corporate bankruptcy. The artificial separation of state corporate law and federal corporate bankruptcy has undermined both areas of the law. In the state corporate law context, state lawmakers fail to consider fully insolvency-related issues because corporate bankruptcy is regulated by Congress rather than the states; yet federal bankruptcy courts frequently look to state law for guidance on precisely those corporate governance issues where state law is likely to be inefficient or inapplicable. I refer to these perverse effects of the federalization of corporate bankruptcy as a "vestigialization"[7]

6. The debate is usually traced to a 1974 article by William Cary that argued that states' efforts to attract corporate charters have led to a "race-for-the-bottom," with states enacting increasingly management-friendly laws at the expense of shareholders because managers ordinarily choose a firm's state of incorporation. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). Cary's race-for-the-bottom thesis was disputed by Ralph Winter, who contended that market forces would impel state lawmakers to enact laws that benefit both managers and shareholders. Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977). Winter's view has become known as the "race-for-the-top" position. These views, and the continuing debate as to the effects of charter competition, are discussed in detail later in this Article. *See infra* Part IV.

7. "Vestigialization" refers to the fact that after the separation of state corporate law and federal corporate bankruptcy, the interaction between these two areas of law is based upon the remnants of what might otherwise have been a cohesive, integrated policy. After Congress federalized corporate bankruptcy, states continued to provide their own collectivized insolvency procedures but lost much

problem. In light of the inefficiencies caused by vestigialization and—ultimately more importantly—by Congress's shortcomings in regulating corporate bankruptcy, I argue that lawmaking authority over corporate bankruptcy should be shifted back to the states.

It is important to emphasize from the outset that this Article does not call for the de-federalization of the entire bankruptcy framework. The systematic cognitive difficulties that undermine the financial decisions made by individuals and that underlie the "fresh start" policy embodied in Chapter 13 bankruptcies are arguably best addressed through a single, national framework regulated and administered at the federal level.[8] Moreover, the personal bankruptcy context lacks the charter competition that shapes state lawmaking in the corporate law context and that makes states better suited than Congress to regulate both general corporate law and corporate bankruptcy.[9] On the contrary, states would be worse, or at least no better, than Congress as regulators of personal bankruptcy. In light of this, my analysis suggests that while authority over corporate bankruptcy should be shifted to the states,[10] Congress should continue to regulate personal bankruptcy.[11]

This Article proceeds as follows. In Part II, I discuss the nineteenth-century debate over whether the states or Congress should regulate corporate bankruptcy. The analysis shows that the current regime—and its separation of state corporate law and federal bankruptcy—is in no way inevitable. In fact, opponents of federalizing corporate bankruptcy held sway through much of the nineteenth century and might plausibly have prevailed if the constitutionality of federal regulation of corporate bankruptcy had been tested in the Supreme Court early on.

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of their incentive to focus either on these procedures or on the implications of financial distress for those corporations that had not yet invoked a collectivized insolvency procedure. As a result, when federal bankruptcy law employs state law in an insolvency issue, it is likely to find only a vestige of a wholly integrated policy decision. *See infra* notes 74-83 and accompanying text for a more complete discussion of vestigialization.

8. *See* Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1437-38 (1985) (arguing that federalization of personal bankruptcy law is desirable due to the pervasive effects of impulsive behavior, incomplete heuristics, and externalities on personal financial decisions).

9. *See infra* subpart IV(A).

10. One potential concern about a decision by Congress to shift corporate bankruptcy to the states while retaining control over personal bankruptcy involves coordination problems. An obvious example is the situation where both an individual and her solely-owned corporation file for bankruptcy. While coordination costs would be increased under a regime in which the former case were federal and the latter case were state, the costs should not be exaggerated. The federal and state courts often would be in the same location, and most issues in the cases would lend themselves to separate treatment.

11. Under the current Bankruptcy Code, Congress also regulates municipal bankruptcy. 11 U.S.C. §§ 901-946 (1988). The arguments for state regulation of corporate bankruptcy would also seem applicable in the municipal bankruptcy context, although the case for limited federal control to prevent opportunistic amendment of state law, *see infra* subpart IV(B), arguably would be stronger with respect to municipal bankruptcy.

In Part III, I discuss the consequences of federalizing corporate bankruptcy. I focus on the vestigialization effect that the artificial separation between corporate law and corporate bankruptcy has produced in three particular areas: state regulation of preferential transfers, derivative litigation in bankruptcy, and corporate voting in bankruptcy.

After considering several possible responses to the perverse effects caused by the gap between state corporate law and federal corporate bankruptcy, I argue in Part IV that Congress should shift authority over corporate bankruptcy back to the states. Not only would state control over all corporate law eliminate the vestigialization problem, but state lawmakers would also be more effective in regulating corporate bankruptcy than Congress has been. State lawmaking is suspect in several areas, however. I therefore argue that rather than relinquishing control altogether, Congress should continue to regulate limited aspects of corporate bankruptcy, such as the applicable disclosure requirements.

In Part V, I consider several potential obstacles to state regulation of corporate bankruptcy, including Contracts Clause limitations and state courts' limited abilities to assert jurisdiction over out-of-state persons and property. None of these obstacles is insuperable but assertion of personal jurisdiction over out-of-state creditors could require special adjustments in some cases.

II. A Brief History of the Federalization of Corporate Bankruptcy

In order to appreciate the origins and significance of the current division between state corporation law and federal bankruptcy law, this Article begins by examining the source of Congress's bankruptcy powers and the history of how these powers have been interpreted. Congress derives its bankruptcy authority from Article I, Section 8 of the Constitution, which states that "Congress shall have Power . . . [t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[12] The language of the Bankruptcy Clause is noteworthy in at least two respects. First, while the clause appears to give Congress a clear grant of authority to make bankruptcy law, the question of what precisely is or is not a "bankruptcy" law has at various times been the subject of great controversy.[13] Second, the Bankruptcy Clause merely vests Congress with the *power* to regulate bankruptcy, thus leaving open the possibility that Congress might decline to exercise its authority over some or even all aspects of insolvency.

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12. U.S. CONST. art. I, § 8, cl. 1 & 4.

13. *See infra* note 29 and accompanying text.

For the past fifty years, the parameters of Congress's bankruptcy powers have been considered so clearly settled in the area of corporate bankruptcy that the subject has not generated any serious discussion. Whatever else they may say about Chapter 11, both courts and commentators uniformly assume that Congress's power to regulate corporate bankruptcy is beyond question and that Congress should in fact exercise its authority under the Bankruptcy Clause.[14] Few seem to doubt that Congress, rather than the states, should and will determine the contours of corporate bankruptcy, just as it does with personal bankruptcy.

Yet the role of federal legislation was not always taken for granted. To the contrary, for the first seventy-five years of our nation's history, commentators fiercely debated whether Congress had any business regulating corporate bankruptcy or whether this facet of insolvency law belonged uniquely to the states.[15] This Part reviews the nineteenth-century debate over the federalization of corporate bankruptcy in some detail. My analysis not only shows the duration and intensity of the debate—an aspect of bankruptcy history that will undoubtedly prove surprising to most contemporary observers[16]—but also suggests that if the debate had been resolved earlier or later than it was, the outcome might have been different.

A. *The Earliest Bankruptcy Clause Debates*

Federal bankruptcy did not become a permanent part of the legislative landscape until the enactment of the Bankruptcy Act of 1898.[17] Rather than a single, enduring bankruptcy statute, Congress passed a series of laws—in 1800,[18] 1841,[19] and 1867[20]—in response to financial crises;

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14. *See, e.g.*, Perez v. Campbell, 402 U.S. 637 (1971) (invalidating a state statute that frustrated Congress's attempts to enact uniform bankruptcy laws); Wright v. Union Cent. Life Ins. Co., 304 U.S. 502 (1938) (expanding congressional power by reading the general powers of the Necessary and Proper Clause into the Bankruptcy Clause); Bradley & Rosenzweig, *supra* note 1, at 1078-79 (proposing a federal law repealing Chapter 11 and replacing it with a "contingent equity" regime); Joseph E. Conley, Jr., *Bankruptcy, Developments in the Law, 1981-1982*, 43 LA. L. REV. 327 (1982) (discussing Congress's constitutional authority to enact uniform laws).

15. *See infra* notes 34-39 and accompanying text.

16. One of the few recent articles that evidences an appreciation of the historical debates over the federalization of corporate bankruptcy is Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 746 n.115 (1991). In contrast to the present Article, Korobkin appears to assume that the federalization of corporate bankruptcy was inevitable and necessary. *See id.* at 745-46 (describing the transition to federal regulation of corporate bankruptcy).

17. Act of July 1, 1898, ch. 541, 30 Stat. 544 [hereinafter Bankruptcy Act of 1898], *repealed by* Bankruptcy Reform Act of 1978, *supra* note 3, § 401(a), 92 Stat. at 2682.

18. Act of Apr. 4, 1800, ch. 19, 2 Stat. 19 [hereinafter Bankruptcy Act of 1800], *repealed by* Act of Dec. 19, 1803, ch. 6, 2 Stat. 248.

19. Act of Aug. 19, 1841, ch. 9, 5 Stat. 440 [hereinafter Bankruptcy Act of 1841], *repealed by* Act of Mar. 3, 1843, ch. 82, 5 Stat. 614.

20. Act of Mar. 2, 1867, ch. 176, 14 Stat. 517 [hereinafter Bankruptcy Act of 1867], *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99.

each of these laws was repealed almost as soon as the particular crisis had passed.[21] Unlike the bankruptcy laws themselves, however, the debate about whether there should be any federal bankruptcy law, and if so what it should look like, was nearly constant.[22]

Much of the early debate centered on disagreements concerning the scope of Congress's authority under the Bankruptcy Clause. To the twentieth-century observer, the power to make "bankruptcy" laws seems to give Congress an all-encompassing source of authority in the context of financial distress. But to many eighteenth-century legal minds, the term "bankruptcy" carried a far different meaning. England had long distinguished bankruptcy laws, which applied only to merchants and traders and could be invoked only by creditors, from the insolvency[23] laws that were passed to protect debtors and operated at their request.[24] Based on this distinction, opponents of expansive federal legislation insisted, both before and after Congress passed the Bankruptcy Act of 1800, that Congress's authority under the Bankruptcy Clause extended only to bankruptcy laws.[25] Thus, Congress could not enact legislation covering debtors other than merchants and traders, and its mandate was limited to involuntary

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21. F. REGIS NOEL, A HISTORY OF THE BANKRUPTCY CLAUSE OF THE CONSTITUTION OF THE UNITED STATES OF AMERICA 131-32, 143, 156 (1918); CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 19, 85, 127 (1935). Both the Bankruptcy Act of 1800 and the Bankruptcy Act of 1841 were viewed as temporary legislation from the beginning; the Bankruptcy Act of 1867 was the first American bankruptcy law that purported to be permanent. *Id.* at 109. However, the law quickly became unpopular and, as a result, met the same fate as the earlier acts. *Id.* at 109, 127.

22. *See* NOEL, *supra* note 21, at 124-30. For a brief overview of the distinct characteristics of each of the nineteenth-century bankruptcy acts, see *infra* Appendix A.

23. In the discussion that follows, the term "insolvency" is used, as the text indicates, to describe a particular kind of early regulation of financially troubled debtors. Except in connection with this limited discussion of the debate about whether Congress's bankruptcy powers comprehend the enactment of what historically had been viewed as insolvency laws, I use the terms "bankruptcy" and "insolvency" in the much broader, lay person's sense. I also assume for the sake of simplicity that firms that file bankruptcy are insolvent. *Cf.* Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 140-42 (1990) (finding that a substantial majority of publicly held corporations that filed bankruptcy were insolvent). However, it should be noted that current Chapter 11 does not require a showing of insolvency as a prerequisite to Chapter 11 relief. *See* Edward J. DeBartolo Corp. v. Child World, Inc. (*In re* Child World, Inc.), 146 B.R. 89, 91 (S.D.N.Y. 1992); *In re* Keniston, 85 B.R. 202, 214 (Bankr. D.N.H. 1988).

24. WARREN, *supra* note 21, at 7. Bankruptcy laws, which were designed to prevent debtors from fraudulently withholding assets from their creditors, provided a mechanism for gathering assets and distributing them to creditors. NOEL, *supra* note 21, at 96-97; WARREN, *supra* note 21, at 7. Insolvency laws enabled debtors, among other things, to petition for release from debtors' prison on a showing they had delivered all of their assets to their creditors. NOEL, *supra* note 21, at 96-97; WARREN, *supra* note 21, at 7.

25. *See, e.g.*, CONG. GLOBE, 26th Cong., 1st Sess. app. at 461 (1840) (remarks of Sen. Wall) (arguing that the proposed Bankruptcy Act of 1841 was unconstitutional because it was an insolvency law and thus beyond the scope of congressional power).

bankruptcy—laws that creditors rather than the debtor invoked.[26]

Unfortunately, the Framers' discussions in connection with the Constitutional Convention of 1787 shed very little light on the intended scope of this congressional power grant. The Bankruptcy Clause was not included in the early drafts of the Constitution, and its appearance in later drafts seems to have provoked very little discussion.[27] The Bankruptcy Act of 1800 applied only to merchants and was involuntary in nature.[28] As a result, the debate between the states' rights advocates, who argued for a narrow, historical construction of bankruptcy, and those who supported far more sweeping federal control remained unsettled well into the nineteenth century.[29]

Somewhat surprisingly, given the controversy that ultimately developed, corporations played almost no part in the first three decades of Bankruptcy Clause debate. When lawmakers debated the scope of the Bankruptcy Clause during these years, both sides assumed that the bankruptcy debtors they were fighting about were individual debtors. Not until 1820 did lawmakers shift their attention to corporations and begin to consider whether the Bankruptcy Clause comprehended corporate debtors.[30]

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26. NOEL, *supra* note 21, at 96-97; WARREN, *supra* note 21, at 7-8.

27. NOEL, *supra* note 21, at 78-80; WARREN, *supra* note 21, at 4-5. The only discussion of the Bankruptcy Clause on record consists of an exchange between Roger Sherman of Connecticut, who feared that Congress might repeat England's practice of making some bankruptcies punishable by death, and Gouverneur Morris, who believed that such fears were misplaced. NOEL, *supra* note 21, at 80. The Bankruptcy Clause is also discussed briefly in *The Federalist*, where Madison describes it as "intimately connected with the regulation of commerce" and considers it as a means of "prevent[ing] so many frauds where the parties or their property may lie or be removed into different States." THE FEDERALIST No. 42, at 271 (James Madison) (Clinton Rossiter ed., 1961); *see also* WARREN, *supra* note 21, at 7 (quoting THE FEDERALIST No. 42, *supra*, at 271 (James Madison)); Kurt H. Nadelmann, *On the Origin of the Bankruptcy Clause*, 1 AM. J. LEGAL HIST. 215 (1957) (discussing brief references to the Bankruptcy Clause in Madison's notes).

28. Bankruptcy Act of 1800 § 1.

29. The first important Supreme Court decision addressing the scope of Congress's authority under the Bankruptcy Clause is Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122 (1819). Chief Justice Marshall's opinion rejected the contention that the Bankruptcy Clause limits Congress to bankruptcy laws, as distinguished from insolvency laws. *Id.* at 194-96. "Th[e] difficulty of discriminating with any accuracy between insolvent and bankrupt laws," he reasoned, "would lead to the opinion, that a bankrupt law may contain . . . insolvent laws; and that an insolvent law may contain those which are common to a bankrupt law." *Id.* at 195. Yet *Sturges* was not a total loss for states' rights advocates. Marshall concluded that the Bankruptcy Clause does not wrest bankruptcy completely out of the hands of the states. He ruled that to the extent that Congress has not acted, the states may fill the void with laws of their own, so long as the state regulation does not offend other constitutional strictures such as the Contracts Clause. *Id.* at 196-97. Moreover, lawmakers not only continued a political debate over the issues Marshall had purported to resolve as a constitutional matter, but they also persisted in treating these issues as open constitutional questions. *See* NOEL, *supra* note 21, at 140-41 (describing Senator John C. Calhoun's insistence that the Bankruptcy Act of 1841 was an insolvency law and, as such, exceeded Congress's powers under the Bankruptcy Clause).

30. A bankruptcy bill that Congress introduced in 1820 stirred what appears to have been the first

The debate continued to simmer thereafter,[31] and finally came to a head in the discussions that culminated in the Bankruptcy Act of 1841. By the late 1830s, whether Congress could, or should, regulate corporate bankruptcy arguably had become the single most important issue under discussion.

Why, in contrast to the battles over Congress's authority to enact an insolvency law or legislation that extended to debtors other than merchants and traders, did the fight over Congress's authority to regulate corporate bankruptcy take so long to develop? The short answer is that corporations simply were not an important economic factor in the early years of the debate. Only in the middle decades of the nineteenth century did corporations emerge as an integral component of the nation's expanding economy.[32] By this time, the merchants and traders, or more accurately the manufacturers and miners, increasingly operated as corporations rather than individual business people.[33] Lawmakers therefore could no longer afford to ignore them.

The opposing factions in the corporate bankruptcy debates divided along much the same lines as lawmakers had in disputing the other issues relating to the scope of the Bankruptcy Clause (and in much the same way as might be the case if the debate were reopened today).[34] Those lawmakers who favored inclusion of corporations saw federal bankruptcy legislation as necessary to eliminate the problem of varied and inconsistent state regulation and contended that corporations were sufficiently integral to commerce that Congress could not effectively regulate bankruptcy unless

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extensive debate over the inclusion of corporations in a federal bankruptcy act. Opponents of inclusion contended that because states charter and otherwise regulate ongoing corporations, Congress could not possibly have the power to break them up. PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA 22 (1974). These policy makers, many of whom were Southerners, also decried the proposal as a ploy by Northern banks to crush Southern and Western banks. *Id.* Those who favored inclusion, on the other hand, insisted that corporations were so inextricably intertwined with commerce that a bankruptcy law that did not apply to corporations would hardly be worth enacting. *Id.* The 1820 bill failed to pass, WARREN, *supra* note 21, at 27-28, as did a proposal in 1827 to amend a bankruptcy bill under consideration to include corporations. *Id.* at 57.

31. In 1837, President Van Buren suggested in a special message that Congress should enact bankruptcy legislation that would only apply to banks. WARREN, *supra* note 21, at 56. Those who opposed his request insisted, among other things, that Congress did not have constitutional authority to enact a bankruptcy law that regulated corporations. *See id.* at 57 (describing five sources of opposition to Van Buren's proposal, including those who believed a bankruptcy bill applicable to corporations would be unconstitutional). Congress failed to act on Van Buren's request. WARREN, *supra* note 21, at 56-57; *see also* NOEL, *supra* note 21, at 136-37 (noting that Daniel Webster, the opposition leader, successfully controverted Van Buren's request to include banks and corporations in the bankruptcy law).

32. *See* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 190 (2d ed. 1985).

33. *Id.* at 189-90.

34. *See supra* note 30.

it included corporations in any bankruptcy legislation it passed.[35] These lawmakers insisted that there was no valid reason to treat corporations differently than individuals for the purposes of a bankruptcy act[36] and prophesied that a failure to extend federal legislation to corporations would serve as an invitation to fraud.[37]

The lawmakers who insisted that Congress could not, and should not, regulate corporate bankruptcy countered with an argument whose power has been largely forgotten today: Because states charter and regulate every other facet of a corporation's existence, they must also be the ones to address the bankruptcy of corporations.[38] In the words of Senator Henry Clay of Kentucky:

> Corporations are artificial beings, created by the States . . . . [The States] know when it is best to make or abolish them.
>
> . . .
>
> . . . I think that their control and management, and the distribution of their funds, can be far better effected by the respective States which have created them than by the legislation of the Federal Government.[39]

In striking contrast to the current assumption of many courts and commentators that Congress always has and always will regulate corporate bankruptcy, these debates make clear that nineteenth-century lawmakers viewed the proper domain of corporate bankruptcy as an open issue. Moreover, it is important to keep in mind that the debate was framed in constitutional as well as political terms. The constitutional argument—

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35. *See* Judith S. Koffler, *The Bankruptcy Clause and Exemption Laws: A Reexamination of the Doctrine of Geographic Uniformity*, 58 N.Y.U. L. REV. 22, 54-55 (1983) (advancing the theory originally put forth by Joseph Story that the Bankruptcy Clause was designed to prevent inconsistent state laws that might hamper interstate commerce).

36. *See* CONG. GLOBE, *supra* note 25, app. at 463 (remarks of Sen. Wall). Senator Garrett B. Wall went even further, contending that the uniformity requirement of the Bankruptcy Clause compelled Congress to treat corporations the same as individuals. *Id.* In his view, a law that included individuals, but did not govern corporations engaging in the same business, would violate this requirement. *Id.* This interpretation of the uniformity requirement was eventually rejected by the Supreme Court. *See* Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188 (1902) (stating that the Bankruptcy Clause requires only geographical, not personal, uniformity).

37. Advocates of federalization insisted both that state lawmakers could not be trusted to draft appropriate bankruptcy legislation, *see supra* note 35, and that exclusion of corporations from the bill would encourage individuals to engage in fraudulent behavior. Senator Wall, for instance, predicted that unscrupulous business people would incorporate their businesses as a means of evading the oversight of a federal bankruptcy regime if corporations were exempted: Would not "corporations and associations . . . become the asylum of fraud, the hiding-place of dishonesty, and the rogue's last refuge?" CONG. GLOBE, *supra* note 25, app. at 463.

38. *See* CONG. GLOBE, *supra* note 25, app. at 848 (remarks of Sen. Clay) ("[T]he States themselves are much more competent than Congress is to exercise all necessary and proper jurisdiction over corporations . . . .").

39. *Id.*

whatever lawmakers might think about the policy issues at stake, Congress simply did not have the constitutional authority to involve itself in corporate bankruptcy—was taken extraordinarily seriously. Even Joseph Story, a consistent supporter of federalization, had second thoughts. "Is it quite certain," he wrote to Daniel Webster, "that State Rights as to the creation and dissolution of corporations are not thus virtually infringed? I confess that I feel no small doubt whether Congress can regulate State corporations by any other laws than State law."[40]

The opponents of extending the proposed legislation to corporations did not simply raise doubts about the inclusion of corporations. In this most hotly contested of all the debates over the status of corporate bankruptcy, their view eventually won out. Just as they had in 1820, opponents thwarted efforts to extend the Bankruptcy Act of 1841 to corporations.[41]

Why was it that, as late as 1841, when corporations had become an important part of the economy and Congress's role in regulating commerce was increasingly recognized, opponents of federalizing corporate bankruptcy still held the winning hand? The explanation for the persistent success of those who thought corporate bankruptcy should be left to the states lies in the remarkably close relationship between states and corporations throughout the nation's history. The following subpart examines the basis for and development of this relationship.

B. *State Regulation and the Origins of the Modern Corporation*

To better appreciate the power of the argument that only the states can and should regulate corporate bankruptcy and to understand how the argument continued to garner substantial support well into the nineteenth century, it is necessary to consider briefly the role states have historically played in corporation law. The overview also will help to explain why Congress finally did federalize this area of bankruptcy and will set the stage for a brief analysis of the significance of these nineteenth-century developments in corporation law and corporate bankruptcy.

In England and elsewhere in Europe, the power to grant corporate charters (and the special privileges that often attended a charter) had long been seen as one of the attributes of sovereignty.[42] During the colonial

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40. 2 LIFE AND LETTERS OF JOSEPH STORY 330 (Boston, Little & Brown 1851), *quoted in* WARREN, *supra* note 21, at 68.

41. *See* Bankruptcy Act of 1841 § 1 (defining eligible bankrupts as all persons owing debts and further elaborating that "all persons" includes "merchants . . . , all retailers . . . , and all bankers, factors, brokers, underwriters, or marine insurers"); *id.* § 14 (extending the scope of the Act to cover partnerships but not corporations).

42. *See* JAMES W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES: 1780-1970, at 3 (1970) ("By the eighteenth century the accepted English doctrine was that only the king in Parliament might create a corporation."); *see also* 2 JOSEPH S. DAVIS, *Eighteenth*

era, the British crown controlled the granting of corporate charters in the colonies, just as it did in England.[43] The colonies, however, did not always wait for royal approval of a given charter request. Rather, colonial assemblies sometimes short-circuited the process, even before the Revolutionary War, by purporting to authorize charters themselves.[44] Following the expulsion of England, and in the absence of an overarching national government, it was therefore a simple and natural step for each of the individual states to assume full authority in this area.[45] Thus began the unique relationship between corporations and state government.

The states' early role as gatekeepers with respect to corporate charters went much further than the ministerial process that we are familiar with today. The role of a state went much further than simply granting charters. Not only did each charter application require special approval by the state (the general incorporation statutes that dramatically reduced the difficulty of obtaining a charter did not become prevalent until well into the nineteenth century[46]), but a high percentage of the early charters were for businesses that performed quasi-public functions such as building turnpikes or bridges or installing municipal aqueducts.[47] Many early corporations were, in a very real sense, simply arms of the state. To encourage entrepreneurs to engage in much needed activities, states frequently gave them monopoly rights, together with other special privileges ranging from the power of eminent domain and freedom from taxation to exemption from the militia for those involved in the corporate enterprise.[48]

Century Business Corporations in the United States, *in* ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 3, 8 (Russell & Russell 1965) (1917) [hereinafter ESSAYS] ("The power of granting corporate privileges, long recognized as an attribute of sovereignty, was assumed by the [American] state governments as the British control was thrown off, and the granting of charters became a function of the law-making body.").

43. *See* 1 JOSEPH S. DAVIS, *Corporations in the American Colonies*, *in* ESSAYS, *supra* note 42, at 3, 6-7; *see also id.* at 17 ("[T]he acts of the assemblies could not become laws until approved by the representatives of the proprietary or the Crown, and they were further subject to annulment by these authorities.").

44. 1 *id.* at 18-20.

45. 2 DAVIS, *supra* note 42, at 8-9.

46. The shift toward general incorporation began when Louisiana abolished special charters altogether in 1845. LA. CONST. of 1845, tit. VI, art. 123. A number of other states developed a dual system of both special and general incorporation between 1845 and 1875. Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129, 143-46 (1985); *see, e.g.*, ILL. CONST. of 1848, art. XI, § 1; N.C. CONST. of 1868, art. VIII, § 1; WIS. CONST. art. XI, § 1 (adopted 1848). General incorporation statutes finally displaced special incorporation altogether in the 1870s and 1880s. HURST, *supra* note 42, at 33; *see* Butler, *supra*, at 153, 152-54 (Table 1: Chronology of Pre-1875 State Constitutional Provisions that Absolutely Prohibited Special Acts of Incorporation).

47. *See* FRIEDMAN, *supra* note 32, at 188-89 (describing the quasi-public nature of corporations in the colonial and early statehood eras); *see also* 2 DAVIS, *supra* note 42, at 21-33 (detailing the purposes for which early state charters were granted).

48. *See* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW: 1780-1860, at 114, 118 (1977) (discussing the propensity for corporations engaged in public activities to demand monopoly

Nor did the role of the state in corporate life end with the issuance of a charter. To ensure the continued viability of the corporations they had chartered (and completion of the public projects undertaken), state governments routinely loaned money to the corporations, authorized them to set up lotteries as a means of raising money, and adjusted tolls to the extent necessary to offset any decline in profits.[49] Together with the states' pervasive involvement came an implicit authority over the terms of a corporation's charter. Just as many corporations assumed that they could rely on assistance from the state if they ran into trouble, it was also widely accepted that a state could alter the charter of an ongoing business and even terminate its existence if a state so chose.[50] On more than one occasion, a state invoked these powers to alter or repeal a charter it had previously granted.[51]

C. *The Last Stand and Eventual Denouement of the Fight Against Federalization of Corporate Bankruptcy*

The close relationship between states and early corporations sheds important light on the question of why opponents of federalization succeeded in preventing Congress from including corporations in federal bankruptcy legislation even as late as 1841, when Congress passed its second major bankruptcy act.[52] To early lawmakers, all of whom were fully aware of the states' pervasive role in the life of a corporation and of the state functions performed by many corporations, the argument that only the states can and should regulate the bankruptcy of corporations would have made (and obviously did make) perfect sense.

But the nineteenth century brought important changes in the relationship between states and the corporations they chartered. As the century

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rights, powers of eminent domain, and tax-exempt status); *see also* 2 DAVIS, *supra* note 42, at 326-27 (discussing state favors to business corporations that included lottery privileges, tax exemptions, loans, and subscriptions). In a sense, corporations acted as agencies of the state that incorporated them and can be seen as a predecessor to the contemporary administrative state.

49. *See* Oscar Handlin & Mary F. Handlin, *Origins of the American Business Corporation*, 5 J. ECON. HIST. 1, 16 (1945) (noting that many corporations took such benefits for granted).

50. 2 DAVIS, *supra* note 42, at 310-16.

51. Pennsylvania, for instance, exercised its authority on several occasions, summarily altering the charter of a college in Philadelphia in 1779 and repealing the Pennsylvania charter of the Bank of North America six years later. *Id.* at 310. While the repeal of the Bank of North America evoked furious protest, the bank eventually gave up its challenge to the repealing act and accepted a new, substantially narrower charter. *Id.* at 313. North Carolina also appears to have revoked one of its charters. *Id.* at 315. Not until Chief Justice Marshall's decision in Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819), and its characterization of a charter as a constitutionally protected contract, did it become clear that states could no longer alter charters at will. *Id.* at 627-54. *See* Handlin & Handlin, *supra* note 49, at 17-18 (commenting that *Dartmouth College* acted as a bulwark against legislative interference).

52. Bankruptcy Act of 1841 § 1; *see supra* note 41.

advanced, the explosion of commercial activity transformed both the nature of corporations and their relationship with the states that chartered them—and ultimately weakened the case against federal corporate bankruptcy legislation in several respects.[53] First, quasi-public activity[54] played a much less central role in the economy as opportunities to make money in mining, manufacturing, and other areas proliferated.[55] Second, the burgeoning number of applications for corporate charters made it impossible for states to review the applications on an individualized basis.[56] Although many states resisted the pressure to abandon special incorporation in favor of general incorporation statutes until the last decades of the century, the character of the incorporation process had already changed for good.[57] Third, many of the privileges states had used to stimulate economic development—including exclusive licenses and the power of eminent domain—tended to hinder competition.[58] In a rapidly expanding economy where investors no longer needed to be coaxed into entrepreneurship, these privileges came to seem not only unnecessary, but even counterproductive.[59]

By the 1840s, the increasingly distant relationship between states and corporations and the explosion of economic growth made the argument favoring a uniform national insolvency regime more persuasive than ever before. By this time, corporations' traditional function as arms of state government was becoming more a historical than an actual fact. In a

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53. Vast improvements in transportation played a particularly important role in the burgeoning of interstate commerce as the development of railroads and canals linked areas that previously had been geographically isolated. GEORGE R. TAYLOR, THE TRANSPORTATION REVOLUTION, 1815-1860, at 74 (1962).

54. *See supra* text accompanying note 47.

55. *See* FRIEDMAN, *supra* note 32, at 189 (noting the increased use of the corporate charter for general commercial goals); HURST, *supra* note 42, at 18 (suggesting that increased use of corporate charters extended the range of ordinary business activities).

56. FRIEDMAN, *supra* note 32, at 190.

57. Whereas Friedman suggests that the volume of demand for special charters forced states to enact general incorporation statutes, *id.*, Butler contends that exogenous factors such as the increasing development of interstate commerce and charter competition among states led to the decline of the special charter. Butler, *supra* note 46, at 153-54. Charter competition developed after the Supreme Court's decision in *Paul v. Virginia*, which made it difficult for states to exclude out-of-state businesses. *See* Paul v. Virginia, 75 U.S. (8 Wall.) 168, 182 (1868) (holding that a state's chartering of a corporation opens the door to all out-of-state corporations wishing to pursue the same business). In Butler's view, state legislators might otherwise have preserved the special chartering system, despite its burden on legislative time, because the system was a source of significant rents. Butler, *supra* note 46, at 130-33.

58. HORWITZ, *supra* note 48, at 114.

59. *See id.* at 130-34 (suggesting that the granting of monopoly privileges was no longer required to promote adequate investments and observing that the economic entrenchment resulting from the lack of competition hindered expanded productivity and technological development). The chilling effect of a monopoly was particularly problematic when the corporation holding the monopoly proved unable to keep pace with the growing demand for its service. *Id.*

sense, then, the debates leading up to the Bankruptcy Act of 1841 were the last great rallying point for the advocates of state dominion in corporate matters. By the time Congress enacted another bankruptcy act in 1867, opponents of the federalization of corporate bankruptcy no longer held the upper hand. The expansion of interstate commerce had continued, strengthening the case of the lawmakers who called for blanket national legislation.[60] Further, with the increased mobility of business, some lawmakers began to argue that states could not effectively regulate bankruptcies that crossed state lines because of their inability to adjudicate the interests of out-of-state creditors and property.[61] States managed to overcome these limitations with the development of equity receiverships at the end of the century,[62] but Congress's greater jurisdictional reach offered an additional argument for federalizing corporate bankruptcy.

Nonetheless, the debate persisted, and some lawmakers continued to argue stridently that Congress could not and should not regulate corporate bankruptcy.[63] But by the time the Bankruptcy Act of 1867 was signed into law, proponents of federal regulation of corporate bankruptcy had successfully included corporations in a federal bankruptcy law for the first

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60. As noted earlier, a key premise of all of the arguments for federal bankruptcy legislation was that a uniform national law was needed to prevent states from enacting inconsistent and arbitrary bankruptcy legislation of the sort that existed in the early years of the nation. *See supra* notes 35-37 and accompanying text; *see also* NOEL, *supra* note 21, at 111-23 (detailing the inconsistencies of the state systems). It is interesting to note that the experience with state regulation of other aspects of corporate law suggests that, at least in the corporate bankruptcy context, concerns about inconsistent and arbitrary corporate laws may have been unfounded. This observation is discussed later in more detail. *See infra* section IV(B)(2).

61. WARREN, *supra* note 21, at 104-05. The difficulty was one of both personal jurisdiction—states could not assert personal jurisdiction over out-of-state creditors—and subject matter jurisdiction—which imposed comparable limitations on a state's authority over foreign property. *See* Ogden v. Saunders, 25 U.S. (12 Wheat.) 213, 368-69 (1827) (holding a state bankruptcy law invalid as applied to an out-of-state creditor because of a lack of personal jurisdiction).

62. *See* 8 SECURITIES AND EXCHANGE COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 30 (1940) [hereinafter SEC REPORT] (noting that separate state receiverships were set up in each of the states where bankrupt companies had property).

63. Senator William A. Howard of Michigan may have been the most vigorous opponent of federalizing corporate bankruptcy in the debates leading up to the Bankruptcy Act of 1867. In support of his motion that language providing for the inclusion of corporations be stricken, Senator Howard argued:

> Corporations in the States draw their being from the statutes of the States, which statutes are called their charters. Their existence, all their attributes, all their liabilities, all penalties imposed upon them, the very life and being, the very soul and essence of a corporation is derived from the State statutes. The States have full and complete control over corporations erected or created by their laws; and I have yet to learn that it is within the constitutional competency of Congress to interfere in any way whatever with the functions or operations of State corporations.

CONG. GLOBE, 39th Cong., 2d Sess. app. at 987 (1867).

time.[64] Corporations once again were included in federal bankruptcy legislation in the Bankruptcy Act of 1898,[65] and corporate bankruptcy has been a permanent part of federal bankruptcy law ever since.[66]

D. *Summary and Implications*

As this historical analysis illustrates, lawmakers did not always see the bankruptcy of corporations as a natural and inevitable component of federal bankruptcy legislation. For much of the first century of the nation's existence, most lawmakers assumed that states rather than Congress would regulate corporate bankruptcy, just as the states regulated nearly every other facet of a corporation's existence. In fact, one might credibly conclude from the analysis that history could easily have unfolded differently.

To appreciate this possibility, notice that the question of whether the Bankruptcy Clause gives Congress the power to federalize corporate bankruptcy was ultimately decided at a political level. Because Congress did not attempt to include corporations in either of the early bankruptcy

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64. *See* WARREN, *supra* note 21, at 109.

65. The Bankruptcy Act of 1898 initially provided for involuntary bankruptcy only for corporations. Only in 1910, when Congress amended the Act to include voluntary corporate bankruptcy, was the federalization of corporate bankruptcy complete. *See* Bankruptcy Act Amendment of 1910, ch. 412, § 4(a), 36 Stat. 838, *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, tit. IV, § 401(a), 92 Stat. 2549, 2682.

66. The suggestion that federalization of corporate bankruptcy was not inevitable casts an interesting light on the securities reforms of the 1930s. As it was, Congress federalized a significant portion of state corporation law with the Securities Acts of 1933 and 1934, and at the same time completely overhauled the Bankruptcy Act of 1898. *See* Securities Act of 1933, ch. 38, tit. I, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77 a-bbbb (1988)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78 a-kk (1988)); Act of Mar. 3, 1933, ch. 204, 47 Stat. 1467 (repealed 1978); Act of Mar. 24, 1934, ch. 345, 48 Stat. 798 (repealed 1978); Act of June 7, 1934, ch. 424, 48 Stat. 911 (repealed 1978) (all three amending the Bankruptcy Act of 1898). Congress also made sweeping reforms in related areas. *See, e.g.*, Banking (Glass-Steagall) Act of 1933, ch. 89, 48 Stat. 162 (codified as amended at scattered sections of 12 U.S.C. (1988)) (separating commercial from investment bankers and protecting depositors by restricting the securities business of commercial banks); Investment Company Act of 1940, ch. 686, tit. I, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to b-21 (1988)) (regulating stock brokers and investment advisors). But what might have happened if all of corporation law—both general corporation law and corporate bankruptcy—were still governed by the states when Congress embarked on its Depression-era reforms?

It is plausible that Congress might have created a regime somewhat like the state-regulated one I propose in Part IV. To be sure, given the extent of the regulatory zeal of the time, Congress probably would have federalized substantially more of corporate bankruptcy than I argue for. But rather than wholly federalizing an entire segment of corporation law—corporate bankruptcy—it is at least possible that Congress might simply have focused on those issues that the states appeared to be regulating ineffectively. For example, Congress could have satisfied its concerns that investors be given adequate information by enacting comprehensive federal disclosure requirements that dealt both with healthy corporations and with those that had filed for bankruptcy. Whether Congress would have deemed this sufficient is less clear, given the Securities and Exchange Commission's belief that a trustee should be appointed in lieu of management in every large case. 8 SEC REPORT, *supra* note 62, at 107-10. Such a framework would have avoided the kinds of problems I discuss in the following Part.

acts,[67] the question never made its way to the courts.[68] But consider what might have happened if, for example, the Bankruptcy Act of 1800 had purported to regulate bankruptcies involving corporations and was thereafter challenged as unconstitutional. Given the close identification of corporations with the states in that era, the Supreme Court quite possibly would have concluded that the Framers of the Constitution never intended Congress to interfere with state sovereignty in this fashion. They might well have held that the Bankruptcy Clause gives Congress broad authority to establish uniform federal bankruptcy laws, but that the clause could not have been designed to disrupt so integral a function of state government as the regulation of a state-sponsored corporation.[69]

To be sure, subsequent events might have undermined the basis for such a decision. While Congress's authority to regulate commerce under the Commerce Clause was initially seen as relatively limited in scope, the Supreme Court construed this power in increasingly expansive terms as interstate commerce mushroomed in the latter half of the nineteenth and early twentieth centuries.[70] Precedent holding that Congress could not regulate corporate bankruptcies might have become problematic, given the importance of corporations to the modern economy and the uncertain ability of

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67. The Bankruptcy Act of 1800 applied to "any merchant, or other person, residing within the United States, actually using the trade of merchandise." Bankruptcy Act of 1800 § 1. The Bankruptcy Act of 1841 covered "[a]ll persons whatsoever, residing in any State, District or Territory of the United States . . . being merchants, or using the trade of merchandise, all retailers of merchandise, and all bankers, factors, brokers, underwriters, or marine insurers." Bankruptcy Act of 1841 § 1. "Persons" in each case was seen as comprehending only natural persons, not corporations. NOEL, *supra* note 21, at 138.

68. Another aspect of the Bankruptcy Act of 1841—the Act's provision for voluntary as well as involuntary bankruptcy—was also perceived to be constitutionally suspect, but it too was never tested in the Supreme Court. WARREN, *supra* note 21, at 86.

69. The Supreme Court's treatment of insurance law offers a fascinating parallel in this respect. Following the Supreme Court's decision in Paul v. Virginia, 75 U.S. (8 Wall.) 168 (1868), it was widely assumed that the sale of insurance did not constitute interstate commerce, and as a result, Congress had no authority to regulate insurance. *See id.* at 183 (holding that a state statute requiring out-of-state insurance companies to obtain licenses in order to conduct business within the state did not violate the Commerce Clause of the Constitution). In consequence, state lawmakers exercised sole authority over both general insurance law and insurance insolvency throughout the nineteenth and early twentieth centuries. In United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944), the Court held that insurance regulation did in fact come within the parameters of the Commerce Clause. *Id.* at 553. But Congress responded by passing the McCarran-Ferguson Act shortly thereafter, thus assuring that the states would continue to regulate both insurance law and insurance insolvency. *See* McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015 (1988)). As suggested in the text, events could easily have developed similarly in the corporate bankruptcy context, resulting in states being given the same authority over corporate bankruptcy that they have with respect to general corporation law.

70. Thus, by 1877 the Supreme Court had held that a wire transmission between two adjoining states constituted interstate commerce, Pensacola Tel. Co. v. Western Union Tel. Co., 96 U.S. 1, 9-10 (1877), and in 1903 the Court also held that the interstate movement of lottery tickets was interstate commerce. *See* Champion v. Ames (The Lottery Case), 188 U.S. 321, 354 (1903).

the states to exercise jurisdiction over all of the necessary parties and property in bankruptcy.[71]

And yet, if the states had developed bankruptcy provisions as part of their corporation laws, and had the provisions kept pace with changes in corporations and the economy, the courts might well have left the precedent largely undisturbed.[72] Bankruptcy might simply have become a historical exception to Congress's ever-expanding role and an established component of state corporation law.[73]

The ultimate point here is not to defend the plausibility of this alternative scenario, but to further reinforce that it is not at all inevitable that corporate bankruptcy be regulated at the federal level. The Bankruptcy Clause does not compel Congress to assert authority in this area, nor was it always clear that Congress even could do so. The observations of this Part therefore raise an important question: What are the consequences of Congress's decision to federalize corporate bankruptcy? And from this question comes another: In light of these consequences, is it possible that the federalization of corporate bankruptcy may have been a mistake?

III. Confusion in the Gap: The Vestigialization Caused by the Separation Between Corporate Law and Corporate Bankruptcy

The previous Part sought to explain from a historical perspective why Congress regulates corporate bankruptcy while authority over other aspects of corporate law is vested in the states. I asked at the end of the Part whether it has mattered that corporate law and bankruptcy are subject to different masters. My purpose in this Part is to show that, rather than simply being a historical curiosity, the separation has produced unfortunate consequences in legal doctrine.

I argue, in particular, that the separation between corporate law and bankruptcy is responsible for what I will refer to as "vestigialization"—that

71. As noted above, the states solved these jurisdictional problems in the equity receivership context with the use of ancillary proceedings. *See supra* notes 61-62 and accompanying text.

72. An interesting question raised by this analysis is why, given that Congress did not federalize corporate bankruptcy until 1867, the states did not enact significant corporate bankruptcy legislation in the interim. Several answers are possible. First, and perhaps most importantly, early corporations rarely failed, both because many were established to achieve specific, limited objectives, and because the state tended to step in to forestall any potential disaster. *See* Handlin & Handlin, *supra* note 49, at 16-17 (discussing the low-risk undertakings for which early corporations were formed). Thus, the possibility of corporate insolvency was addressed on an ad hoc basis, rather than through legislation, in the early years. Second, even after the Supreme Court upheld states' right to enact bankruptcy legislation in Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122, 196-97 (1819), the scope of state authority to regulate corporate bankruptcy was subject to doubt.

73. In addition to the jurisdictional questions alluded to here, several other obstacles might limit the ability of the states to enact effective bankruptcy laws. I discuss these obstacles in more detail later in this Article. *See infra* Part V.

is, the systematic neglect (by state or federal lawmakers, or both) of issues that fall in the gap between general corporation law and corporate bankruptcy.[74] These effects seem to stem from two different phenomena. First, states have insufficient reason or opportunity to focus (in connection with either the legislative or judicial process) on corporate governance issues as they relate to insolvent corporations[75] because insolvent corporations that are unable to resolve their financial distress through private workout, and whose difficulties continue, usually wind up in bankruptcy, where they are subject to federal bankruptcy laws and federal court precedents.[76] Due to the existence of an overarching federal bankruptcy regime, states have paid little attention to their own collectivized insolvency procedures[77] and, with a few sporadic exceptions, have largely ignored the implications of insolvency in developing their general corporation law.[78]

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74. It is important to emphasize that the analysis which follows does not suggest that vestigialization will occur whenever state and federal law govern the same area. Rather, vestigialization is an artifact of the particular tensions incident to the separation between state corporate law and federal corporate bankruptcy that are discussed below. *See infra* subparts III(A)-(C).

75. By "insolvent corporations" I mean corporations whose liabilities are greater than their assets. I am not using the term "insolvent" in the specialized sense employed in the nineteenth-century debates over the appropriate scope of the Bankruptcy Clause. *See supra* note 23.

76. The principal comparison here is between federal bankruptcy laws and state statutory alternatives to federal bankruptcy, such as state assignment-for-the-benefit-of-creditors provisions. (I describe these provisions as "collectivized insolvency procedures" below. *See infra* note 77.) A recent survey by the Fraudulent Transfers Task Force of the Corporate, Banking, and Business Section of the Pennsylvania Bar Association confirms the widespread perception that troubled corporations rarely invoke the state law procedures. The Task Force asked members of the Corporate, Banking, and Business Section how frequently they used Pennsylvania's statutory insolvency procedures. While many of the members regularly dealt with the federal bankruptcy laws, few had any significant experience with the state law procedures. Telephone Interview with Joy Conti, Chairperson of the Fraudulent Transfers Task Force (Mar. 14, 1994). My own review of Pennsylvania caselaw reinforced the impression that the state law procedures are rarely used. The supplement to the annotated version of the Pennsylvania provisions contains only 18 different reported decisions for the years 1954-1992 (excluding six decisions where the provisions were construed in a federal bankruptcy proceeding). *See* 39 PA. CONS. STAT. ANN. §§ 1-216 (1992 Supp.). *See generally* James E. McCarty, *Federal Bankruptcy or State Court Receivership*, 48 MARQ. L. REV. 340, 348-49 (1965) (noting that there were more insolvencies in federal bankruptcy courts than in Wisconsin state courts).

77. I use the term "collectivized insolvency procedure" to refer to statutory provisions that are designed to provide a global—that is, a multiparty—response to financial distress, in contrast to provisions, such as default remedies, that merely provide for adjudication of a dispute between the debtor and an individual creditor. Federal bankruptcy law, state assignment-for-the-benefit-of-creditors provisions, and state receivership laws are collectivized insolvency procedures.

States' lack of attention to their collectivized insolvency proceedings arguably is evidenced by the rarity with which the procedures are adjusted in any significant way. For further discussion focusing in particular on state regulation of preferential transfers, see *infra* notes 100-01 and accompanying text.

78. The occasional suggestion by a state court that directors owe fiduciary duties to creditors of an insolvent corporation represents one situation where states consider insolvency issues and illustrates the primitive state of this inquiry. *See infra* note 99.

An obvious problem with underdeveloped state laws in these areas is that not all financially troubled corporations that fail to effect a workout privately, and whose financial distress continues, do in fact file for bankruptcy. Some liquidate outside of bankruptcy or invoke state collectivized insolvency procedures, such as the state's receivership or assignment-for-the-benefit-of-creditors provisions. As a result, for these corporations the drama of financial distress is played out against a backdrop of inefficient and often ineffective corporate governance rules.

The second phenomenon can be traced to federal bankruptcy courts' tendency to incorporate rather than override relevant state law wherever possible, an inclination that has been approved both by the Supreme Court and by most commentators.[79] Because bankruptcy courts are particularly deferential to state law in the corporate governance context,[80] we are left with a disturbing irony: States spend little time developing insolvency-specific general corporation law, yet their pronouncements (or lack thereof) on these issues may be seen as dispositive not only under state law but also in federal bankruptcy courts.[81]

In the subparts that follow, I describe in detail the effects of vestigialization in three particular areas. The first of these areas, state preference law, illustrates the antiquated status of states' collectivized insolvency regimes.[82] I argue that states' erratic regulation of preferences results

79. *See* Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."). Douglas Baird and Thomas Jackson articulated the most well-known normative justification for looking to state law in most bankruptcy contexts: the creditors' bargain theory of bankruptcy. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984). Baird and Jackson are concerned primarily with creditors' property rights. *See* JACKSON, *supra*, at 5 (stating that a focus of bankruptcy law "is that of bankruptcy as a collective debt-collection device, [that] deals with the rights of creditors"); Baird & Jackson, *supra*, at 100 (suggesting that bankruptcy laws and bankruptcy proceedings should not interfere with the creditors' rights to use the debtor's assets, even where those rights are less than absolute). Other commentators (some of whom are not sympathetic to the creditors' bargain model) have argued that bankruptcy courts should incorporate state corporate governance rules into the bankruptcy context. *See, e.g.*, Michael A. Gerber, *The Election of Directors and Chapter 11: The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever*, 53 BROOK. L. REV. 295, 297 (1987) (arguing that shareholders should be permitted to hold a shareholders' meeting to vote on directors while the corporation is in bankruptcy).

80. *See, e.g.*, Lionel Corp. v. Committee of Equity Sec. Holders of the Lionel Corp. (*In re* Lionel Corp.), 30 B.R. 327, 329-30 (Bankr. S.D.N.Y. 1983) (denying a motion for a preliminary injunction, thus forcing Lionel to respond in state court to a petition seeking to compel a shareholders' meeting).

81. The effect might even be characterized as "double vestigialization," because vestigialized state law ends up applying not only outside of bankruptcy, but also within. For simplicity, I will refer both to state lawmakers' neglect of insolvency-related issues and to the effects of this neglect in the bankruptcy context as "vestigialization."

82. As I suggest below, regulation of preferential transfers is an important component of a collectivized insolvency regime. *See infra* notes 84-86, 95-99 and accompanying text. States' dubious

from vestigialization. The second and third areas I discuss—derivative suits and corporate voting—exemplify the other aspect of vestigialization described above: bankruptcy courts' tendency to incorporate state corporate governance law into the bankruptcy context, despite the fact that the state laws in question were not developed with insolvent corporations in mind.

Given states' tendencies to enact generally efficient corporation laws in response to market forces,[83] their failure to focus on insolvency issues—that is, their susceptibility to the effects of vestigialization—is somewhat puzzling. I consider this puzzle and several possible explanations at the end of this Part.

A. *State Prohibition of Preferential Transfers*

The avoidance of eve-of-bankruptcy preferences has long been seen as integral to federal bankruptcy, as evidenced by the important role that preference provisions have played in every federal bankruptcy statute since the Bankruptcy Act of 1841.[84] The current Bankruptcy Code is not an exception; Section 547 of the Bankruptcy Code regulates preferential transfers in great detail.[85]

Not every insolvent corporation is subject to Section 547, however. As noted above, some financially troubled corporations liquidate or invoke state law receivership or assignment-for-the-benefit-of-creditors provisions rather than filing for bankruptcy.[86] For these corporations, state rather than federal law governs. Because preference regulation tends to further the goals of insolvency regulation, we might expect the states to have enacted their own preference provisions to address the preferential transfers made by those insolvent corporations whose fate is decided in the state law domain.

Unfortunately, while many states do have preference provisions on the books, states regulate preferences in a remarkably haphazard fashion. An analysis of state preference law reveals that the majority of states have no

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regulation of preferences in connection with their collectivized insolvency procedures is indicative of the neglected state of the collectivized procedures as a whole.

83. This issue is discussed in detail in Part IV.

84. *See* John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 253-59 (1981) (examining the historical development of preference law provisions).

85. 11 U.S.C. § 547 (1988). Section 547 authorizes the trustee to avoid preferential transfers made by the debtor to any of its creditors during the 90 days before bankruptcy unless the transfer qualifies for one of the safe harbors set forth in Section 547(c). *Id.* § 547(b). For insiders, the preference period is a full year. *Id.* § 547(b)(4)(B).

I do not intend to suggest that Section 547 is ideal. To the contrary, as the following discussion in the text indicates, the existing evidence suggests that the Bankruptcy Code's regulation of preferences is deficient in many respects. *See infra* text accompanying notes 103-13.

86. *See supra* note 76 and accompanying text.

general preference law whatsoever, aside from laws that apply in the specialized context of bank or insurance company insolvency.[87] In states that have no general preference laws, an insolvent corporation can, at least in theory, make preferential transfers with impunity.[88] Those states that do regulate preferences tend to take two different kinds of approaches. Roughly half of the states establish a reachback period and provide for the avoidance of any preferential transfer that the corporation makes during that period, much as the current Bankruptcy Code does.[89] Other state statutes require a showing of intent to prefer some creditors at the expense of others.[90] Yet even within each of these particular approaches, the individual statutes often vary significantly in their details.[91]

At first glance, one might object to my characterization of state preference law as haphazard. In the corporation law context, commentators often cite the variability among state laws as a significant advantage of state lawmaking.[92] Not only does the competition among states to

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87. A state-by-state summary of the status of state preference law throughout the country is provided in Appendix B. I owe special thanks to Dennis McCarthy for his work on this Appendix. As the summary reveals, only 22 of the 50 states have a general state preference law (that is, a provision other than the special preference provisions some states have enacted for the bank or insurance insolvency context, or a preference provision enacted as part of the Uniform Fraudulent Transfer Act). The remaining 28 states do not have a general state preference law.

88. Some of the states that lack preference statutes have recently enacted the Uniform Fraudulent Transfer Act (UFTA), which covers some preferential conduct. UNIF. FRAUDULENT TRANSFER ACT § 5(b), 7A U.L.A. 639, 657 (1985). The UFTA, however, only partially fills the gap left by the absence of a preference provision. *See infra* notes 107-08 and accompanying text. Creditors also have the option of filing an involuntary bankruptcy petition, thereby insuring the application of federal bankruptcy law. *See* 11 U.S.C. § 303(b)(1) (1988) (allowing three or more creditors, with claims aggregating $5000, to file a petition in appropriate circumstances). But filing for involuntary bankruptcy often will not be a realistic alternative due to factors such as the costs to a small group of creditors of filing and defending an involuntary petition, the creditors' limited access to relevant information, and the risk to the creditors that the filing will be found to have been inappropriate. Moreover, a creditor who is well informed about the debtor's status often will be better off trying to collect her debt outside of bankruptcy than she would be if the debtor were put into bankruptcy. This is because an unsecured creditor must share with other creditors on a pro rata basis in bankruptcy, whereas she may collect payment in full outside of bankruptcy.

89. Eleven states provide a specified reachback period. *See, e.g.*, CAL. CIV. PROC. CODE § 1800(b)(4) (West Supp. 1991) (creating a 90-day period); MD. COM. LAW CODE ANN. § 15-101(d) (1990) (creating a 90-day period); N.H. REV. STAT. ANN. § 568:27 (1986) (creating a three-month period); N.J. REV. STAT. ANN. § 2A:19-3 (West 1987) (creating a four-month period); N.C. GEN. STAT. § 23-3 (1988) (creating a four-month period); PA. STAT. ANN. tit. 39, § 151 (1954) (creating a four-month period); S.C. CODE ANN. § 27-25-20 (1991) (creating a 90-day period); S.D. CODIFIED LAWS ANN. § 54-9-13.2 (1990) (creating a four-month period); TENN. CODE ANN. § 47-13-116 (1988) (creating a three-month period); WASH. REV. CODE § 23.72.030 (1974) (creating a four-month period); WIS. STAT. ANN. § 128.07 (West 1989) (creating a four-month period).

90. *See, e.g.*, OHIO REV. CODE ANN. § 1313.56 (Baldwin 1988).

91. *Compare id.* (requiring that there be a "design to prefer" a creditor as a prerequisite to avoidance) *with* OKLA. STAT. tit. 24, § 31 (1991) (providing that a determination of a preferential transfer is subject to other state law provisions and including no intent requirement).

92. *See, e.g.*, Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 191 (1985) (arguing that variant state corporate laws are beneficial

attract corporate charters cause states to pass corporation laws that are more efficient than they would otherwise be,[93] but states also are able to tailor their laws to particular kinds of corporations to an extent that would not be possible with a uniform federal statute.[94] But a close examination of state preference laws reveals that the differences we find in this context are not the result of competition or adaptation.

Consider, for example, the fact that most states do not have any preference provision.[95] Could the absence of such provisions be the result of competition rather than neglect? Although most commentators see preference law as a crucial component of bankruptcy, a few have begun to take issue with the traditional consensus on this issue. At least one commentator has argued that a debtor's decision to prefer some creditors rather than others prior to bankruptcy is likely to reflect conscious, desirable efforts to distribute loss.[96] From this perspective, federal preference law interferes with what otherwise might be a far more efficient loss-allocation system.[97] Thus, rather than reflecting a failure to efficiently regulate the insolvency process, as I have suggested, it may simply be that the twenty-eight states that do not have a preference law in place are the ones who have gotten it right, and Congress (as well as the other states) are the inefficient ones.[98]

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because they create "jurisdictional competition in the market" that "is desirable because it produces a variety of standard-form contracts from which firms can select the appropriate role for legal rules in their governance structure"); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" vs. Federal Regulation*, *in* ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 100, 109 (Richard A. Posner & Kenneth G. Scott eds., 1980) (claiming that differing state corporate laws allow firms to "take advantage of the competition among states" and to "locate in a state which offers an efficient set of restrictions on the firm, given the firm's anticipated production-investment and financing decision").

93. Not all commentators agree that states do enact relatively efficient laws. *See infra* subpart IV(A) (discussing the various positions on the efficiency of state laws).

94. *See* Baysinger & Butler, *supra* note 92, at 179 (theorizing that because different firms have different optimal structures, firms will select their state of incorporation adaptively); Dodd & Leftwich, *supra* note 92, at 111 n.4 ("[I]n recent years, quite a few states have adopted special statutes or provisions to deal with the special needs of small, closely-held corporations.").

95. *See supra* note 87 and accompanying text.

96. *See* James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 50 (1991) ("Debtors will tend to prefer those creditors who have specialized in dealing with them and whose losses from nonrepayment therefore are likely to be greatest, leaving unpaid those whose losses are relatively less severe.").

97. *See id.* at 51 ("Bankruptcy law's formula, which eliminates (through preference law) the expectation of the lender and borrower that the lender will be paid first, tends to discourage investment by both parties in assets and measures that minimize the total costs of their transactions.").

98. Barry Adler has suggested an alternative argument for eliminating federal preference law. Whereas Bowers assumes that the parties would do without preference regulation if Section 547 of the Bankruptcy Code were abolished, Adler suggests that they could devise their own preference law by contract. Adler, *supra* note 1, at 330. While this approach might prove effective for some companies, contracting and enforcement costs (including the practical impediments to overcoming collective action

One obvious problem with this view of preferences, from a normative perspective, is that it fails to account for a debtor's less benign reasons for preferring some creditors over others. While many prebankruptcy preferences may reflect a debtor's legitimate efforts to allocate scarce resources in the face of financial distress, others stem from insiders' less appropriate desires to help themselves to the firm's assets at the expense of other creditors.[99]

The attempt to vindicate the absence of preference law in so many states proves even more problematic from a positive perspective. If the patterns one observes in state treatment of preferences resulted from a careful and efficient state lawmaking process, we might expect the states periodically to have amended the provisions in order to fine-tune their preference law to reflect changes in the corporate and legal landscape.[100] Yet the reality is almost precisely the opposite. Rather than having been periodically updated and improved, many of the state preference statutes that do exist have not been touched for decades.[101]

In short, state preferences laws are a classic example of the phenomenon I have described as "vestigialization." Because an insolvent corporation is much more likely to file for bankruptcy than to invoke a state's collectivized insolvency procedure,[102] states have little incentive to pay much attention to their insolvency provisions. As a consequence, state law

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problems) suggest the need, at the least, for a state-supplied background rule. *See* Skeel, *supra* note 1, at 506 n.148 (discussing the possible limitations of a private ordering approach).

99. *See, e.g.*, *In re* Philadelphia Light Supply Co., 39 B.R. 51 (Bankr. E.D. Pa. 1984) (permitting a creditors' committee to commence a preference action against the president and sole shareholder of a Chapter 11 debtor for assets improperly withdrawn from the corporation). That courts perceive the need for an effective state preference provision is evidenced by their willingness to create judicial remedies for creditors who have been prejudiced by pre-insolvency preferences in states that lack an applicable preference provision. Some courts remedy the situation by declaring that the preferential transfer violated a fiduciary duty owed by directors to a firm's creditors when a firm becomes insolvent. *See, e.g.*, *In re* STN Enterprises, 779 F.2d 901, 904 (2d Cir. 1985) (interpreting Vermont law to hold that directors of an insolvent corporation owe a fiduciary duty to creditors); *see also* Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1513-18 (1993) (suggesting that most cases in which courts have held that directors owe a fiduciary duty to creditors involved preferences or fraudulent conveyances).

100. The failure to amend a statute for many years does not necessarily mean that lawmakers have neglected it, of course. Some statutes may be so enduring and effective that they do not require tinkering. But one would expect to see at least minor changes.

101. For instance, New Hampshire's preference provision, N.H. REV. STAT. ANN. § 568:27 (1986), has not been amended since 1885; the Colorado provision, COLO. REV. STAT. § 6-10-104 (1989), dates to 1897. Appendix B sets forth the dates when each of the extant state provisions was last amended.

102. The Fraudulent Transfers Task Force of the Corporate, Banking, and Business Section of the Pennsylvania Bar Association recently surveyed the members of the section to determine how frequently they used the state collectivized insolvency procedures. While many of the members regularly dealt with the federal Bankruptcy Code, few had any significant experience with state insolvency procedures. Telephone Interview with Joy Conti, Chairperson of the Fraudulent Transfers Task Force (Mar. 14, 1994).

insolvency procedures are likely to be flawed in significant and troubling respects.[103]

In contrast to the generally erratic status of state preference law, one does find a more sensible treatment of preferences in two particular areas: insurance insolvency and uniform fraudulent conveyance actions. In the insurance insolvency context, nearly every state has an insurance preference provision, and many have been enacted or meaningfully amended in recent years.[104] While this fact may seem at first to conflict with my vestigialization account, on inspection, these statutes actually confirm it. Rather than extensively regulating insurance insolvencies, as it does with other financially troubled companies via the Bankruptcy Code, Congress has left all aspects of insurance law, including the treatment of insolvent insurance corporations, to the states.[105] Thus, insurance law is a context where state insolvency procedures matter. As a result, states have much more incentive to pay attention to insolvency issues with insurance companies than they do with other kinds of business associations.[106] The observation that nearly every state has enacted an insurance-related preference statute is therefore fully consistent with the superior attentiveness we would expect to find.

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103. This is not to say that the existing federal preference laws are ideal. On the contrary, the current federal framework appears to be only partially effective in addressing prebankruptcy preference activity. *See* McCoid, *supra* note 84, at 262-68 (arguing that preference law is not fully effective because individual creditors have incentives to ignore it). In addition to questions about the regulatory strategy embodied in Bankruptcy Code § 547, another problem, at least in small cases, is that debtors-in-possession often do not attack preferences that are covered by the preference provision. Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System*, 70 MARQ. L. REV. 159, 196-97 (1987). Yet even a marginally effective federal law is greatly preferable to the current status of state preference regulation.

104. Forty-eight of the fifty states have an insurance-related preference statute on the books and seventeen of the provisions have been amended in the past three years. For a state-by-state breakdown of these provisions, see *infra* Appendix B. By contrast, bank preference provisions are less common, appearing in only 22 states, and seem to reflect some of the vestigialization effects that have undermined states' general preference laws. *See infra* Appendix B. This is due in part to the fact that a federal receiver routinely takes over if a state bank becomes insolvent, despite the fact that states have their own bank insolvency law framework. *See* Jonathan R. Macy & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1173 (1988); M. Mazen Anbari, Comment, *Banking on a Bailout: Directors' and Officers' Liability Insurance Policy Exclusions in the Context of the Savings and Loan Crisis*, 141 U. PA. L. REV. 547, 550-51 (1992).

105. Congress did so explicitly by enacting the McCarran-Ferguson Act. *See* McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015 (1988)); *see also supra* note 69 (summarizing the history of the Act).

106. Because insurance insolvencies historically have been relatively uncommon, state lawmakers may arguably be less attentive to this aspect of insolvency than they are in an area such as general corporate law. *See* Spencer L. Kimball et al., *Rehabilitation and Liquidation of Insurance Companies: Delinquency Proceedings in Insurance*, 1967 INS. L.J. 79, 79-80 (noting the relative infrequency of insurance insolvencies and the lack of case law interpreting existing statutes). But—as my review of the preference provisions appears to bear out—the applicability of state law to any insurance company that does in fact fail gives states far more reason to focus on insurance insolvency procedures than they would have if insurance insolvency regulation were federalized.

Second, in recent years, many states have enacted the Uniform Fraudulent Transfer Act (UFTA) or the Uniform Fraudulent Conveyance Act (UFCA).[107] While these statutes focus primarily upon fraudulent conveyances, Section 5(b) of the UFTA does provide for the avoidance of certain preferential transfers.[108] Section 5(b) only partially cures the problems of state preference law, however, because it applies only to preferential transfers made to insiders, not to those made to a creditor.[109] Yet even a partial solution markedly improves on states' present regulation of preference law. Because these statutes reflect the work of a uniform laws process, rather than of the states themselves, they do not undermine the vestigialization thesis. On the contrary, the drafters implicitly recognized the effects of vestigialization and attempted to provide an external solution. While this suggests that the uniform laws process might help to solve the vestigialization problem—a possibility I discuss in detail in subpart IV(A)—the important points for present purposes are: (1) the federalization of bankruptcy has led to a marked vestigialization of state preference law; and (2) the uniform fraudulent conveyance acts have at best provided only a partial solution, even in those states that have adopted a uniform law.

The analysis thus far has focused exclusively on the perverse effects that the vestigialization of state preference laws can have for corporations that liquidate or invoke a state law insolvency statute. Ironically, these same provisions also can at times come into play in the bankruptcy context. The case of *In re Rexplore Drilling, Inc.*[110] is illustrative. In that case, a trustee for a bankrupt company sought to invoke Kentucky's general preference statute so that he could take advantage of the provision's more generous reachback period.[111] Based on the language of Section 544(b) of the Bankruptcy Code, which permits creditors to invoke any statute that would be available to them under state law,[112] a divided panel of the Sixth Circuit held in favor of the trustee, thus enabling the trustee to use an antiquated Kentucky statute to circumvent the Bankruptcy Code's narrower preference provision.[113]

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107. *See* UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 639 (1985); UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 427 (1985). For a listing of which states have enacted one of these statutes, see *infra* Appendix B.

108. UNIF. FRAUDULENT TRANSFER ACT § 5(b), 7A U.L.A. 639, 657 (1985).

109. *Id.*

110. Perkins v. Petro Supply Co. (*In re* Rexplore Drilling, Inc.), 971 F.2d 1219 (6th Cir. 1992).

111. *Id.* at 1220-21.

112. 11 U.S.C. § 544(b) (1988).

113. *In re* Rexplore Drilling, Inc., 971 F.2d at 1225. The Kentucky statute authorizes the avoidance of any "act or device done or resorted to by the debtor, in contemplation of insolvency and with the design to prefer one or more creditors." KY. REV. STAT. ANN. § 378.060 (Michie/Bobbs-Merrill 1972). The chief advantage of the Kentucky statute is that it appears to provide a preference

A case such as *In re Rexplore Drilling, Inc.* can only arise where the state has a general preference law on the books, and the law can be construed more expansively than Section 547 of the Bankruptcy Code. To the extent this condition exists,[114] the Sixth Circuit's interpretation of Section 544 can exacerbate the problems that vestigialization already causes in the state law context. In short, the vestigializing effect of the Bankruptcy Code on state preference law should be seen as a malignant consequence of the separation between corporate law and corporate bankruptcy—one that can affect not only those insolvencies that take place outside of bankruptcy, but also a few that take place within.

B. *Bankruptcy and Shareholders' Derivative Suits*

While the derivative litigation procedures in most states are decidedly imperfect, the derivative mechanism is, in many respects, far worse in bankruptcy. Why is this so? Once again, the problem seems to stem in important part from the vestigialization caused by the separation between corporate law and corporate bankruptcy. The vestigialization at issue in this context results from bankruptcy courts' attempts to incorporate into the bankruptcy context state law procedures that were never designed with insolvent corporations in mind.

The derivative suit mechanism serves, at least in theory, as a solution to an intractable corporate governance problem: the absence of sufficient incentives for widely scattered shareholders to participate in monitoring managers.[115] Derivative litigation addresses this dilemma by obviating an individual shareholder's need to contribute directly to the monitoring effort. In the event of managerial misconduct, derivative lawyers file a lawsuit on behalf of the firm's shareholders; the lawyers take their fees from any recovery,[116] and every shareholder benefits from the derivative attorneys' vigorous prosecution of meritorious litigation.

Unfortunately, as numerous commentators have noted, the incentives of derivative suit attorneys, who turn out to be the real parties in interest in these cases, diverge in significant respects from those of the shareholders they purportedly represent.[117] Rather than maximizing the size

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period of potentially unlimited duration, whereas Section 547 of the Bankruptcy Code sets the preference period for transfers to a non-insider at 90 days. 11 U.S.C. § 547(b)(4)(A) (1988).

114. Six states currently have general preference laws that set preference periods longer than ninety days. *See supra* note 89. Other states, such as Kentucky, do not set specific periods for avoidance of preferential transfers. *See supra* notes 90-91 and accompanying text.

115. *See* ROBERT C. CLARK, CORPORATE LAW § 15.1, at 639 (1986) (noting that the derivative suit is "one of the most interesting and ingenious of accountability mechanisms for large formal organizations").

116. *Id.* § 15.8, at 659-60.

117. John Coffee and others have addressed this problem in detail. *See, e.g.*, John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement*

of recovery for plaintiffs, the attorneys have an incentive to maximize the size of their own fee award. For several reasons, the attorneys' concern for their fees will cause them to accept settlement offers that, from the perspective of the plaintiffs themselves, are inadequate. First, plaintiffs' attorneys have an incentive to settle whenever possible, rather than taking a chance on litigation, because they litigate on a contingency basis and thus will receive nothing if they take the case to trial and lose.[118] Second, settlement not only assures the attorneys a recovery, but it also gives them significant control over the size of their fee award.[119] As a result, a plaintiffs' attorney may implicitly collude with defendants to maximize the attorney's recovery at the expense of the class.[120]

In addition to their incentive to enter into inefficient settlements, plaintiffs' attorneys also have an interest in diversifying their litigation portfolio so as to minimize their overall risk. The primary diversification strategy of most plaintiffs' firms is to file numerous lawsuits and invest a small amount of resources in each one, rather than aggressively pursuing a few potentially meritorious lawsuits.[121] As a result, the attorneys will systematically underinvest in the lawsuits they file. The advent of special litigation committees[122] has exacerbated this tendency. Because special

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of Law Through Class and Derivative Actions, 86 COLUM. L. REV. 669 (1986) [hereinafter Coffee, *Understanding the Plaintiff's Attorney*]; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5 [hereinafter Coffee, *Unfaithful Champion*]; Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991) (extending Coffee's insights).

118. If the defendants are directors of the corporation, as usually is the case, they too have an incentive to settle because their costs will not be reimbursed by the firm if the case goes to trial and the defendants lose. Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 117, at 715. Thus, by settling the case, both parties effectively shift their costs to the corporation. *Id.* at 716.

119. Derivative attorneys have a particularly high degree of control over their fees if the court calculates fees under the commonly used lodestar approach, which bases the fee determination on the number of hours worked at a given hourly rate. *Id.* at 717 & n.130. Because they know that a court is likely to approve a fee request for 20% to 30% of the proceeds of a settlement, the attorneys can delay settlement until they have generated fees in roughly that amount. *Id.* at 717-18. As a result, some courts have begun to move away from the lodestar approach and instead base the fee award on a specified percentage of the recovery or on a combination of the two approaches. *See, e.g.*, *In re* Avon Prods., Inc. Sec. Litig., [Current] Fed. Sec. L. Rep. (CCH) ¶ 97,061 (S.D.N.Y. Nov. 6, 1992) (approving a fee award of 30% of the total settlement value); *In re* Warner Communications Sec. Litig., 618 F. Supp. 735 (S.D.N.Y. 1985) (holding that in addition to the lodestar approach, the court must also consider, among other things, the requested fee in relation to the settlement), *aff'd*, 798 F.2d 35 (2d Cir. 1986); *see also* Richard A. Spehr, *Attorney's Fees Update: Awarding Attorneys' Fees in Securities Class Actions*, N.Y. L.J., Apr. 22, 1993, at 5 (describing recent cases and the criticism both methods of calculating fees have received).

120. Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 117, at 714-16.

121. *Id.* at 711; Coffee, *Unfaithful Champion*, *supra* note 117, at 22-23.

122. Special litigation committees, which became increasingly popular in the 1970s and 1980s, are committees of the board of directors composed of directors who are not implicated in the particular derivative action and who are given authority to investigate the action and decide on behalf of the board

litigation committees have enhanced the ability of managers to eliminate even meritorious litigation, plaintiffs' attorneys cannot afford to fully invest in even the most promising suits in their litigation portfolio.[123]

Curiously, while commentators have fully documented each of the shortcomings of the derivative suit device, none has considered the impact of bankruptcy on the incentives of plaintiffs' attorneys. Yet, because many firms whose managers have committed egregious breaches of their fiduciary duties also may be candidates for bankruptcy, bankruptcy is an important piece in the derivative suit puzzle.

What is the effect of bankruptcy? Even more than the appointment of a special litigation committee outside of bankruptcy, the filing of a bankruptcy petition spells doom for most derivative suits filed against the corporation's managers. Because of the frequent death of a derivative suit in the event a firm files for bankruptcy—a phenomenon I refer to as bankruptcy's "black hole effect"—plaintiffs' attorneys are likely to discount the value of any given case, that is, diminish their initial investment to reflect the possibility of bankruptcy. Thus, bankruptcy exacerbates the incentives for plaintiffs' attorneys to underinvest in the individual lawsuits in their portfolio.

The obvious question raised by the current status of derivative suits in bankruptcy is what causes this black hole effect? Why is it that derivative suits almost invariably disappear in bankruptcy? The ineffectiveness of derivative litigation in bankruptcy arguably can be traced to the assumption that procedures employed outside of bankruptcy can simply be imported into bankruptcy unchanged. Yet, for several reasons, the shareholder derivative mechanism in place outside of bankruptcy will, by itself, be particularly ill-suited to the Chapter 11 context. First, while the shareholders of a healthy firm are its true residual owners and, as a result, are the appropriate plaintiffs of a derivative suit outside of bankruptcy, most corporations have become insolvent by the time they file for bankruptcy.[124] Because they have little financial interest in an insolvent firm, and

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as a whole whether it should be pursued. Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 117, at 721. One of the apparent attractions of special litigation committees to a corporation's directors is that they enable a board to retain control of even those suits with respect to which directorial conflicts of interest are sufficiently serious that demand would otherwise be excused—that is, in the absence of such committees, shareholders would be entitled to sue directly rather than be required first to obtain the imprimatur of directors who are themselves the subject of the suit. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 785-89 (Del. 1981) (indicating that, even where a demand is excused, a committee composed of independent and disinterested directors can properly act for the corporation to dismiss derivative litigation after concluding a reasonable investigation); Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 117, at 720-21 (noting recent judicial acceptance of special litigation committees "as a means by which a corporation's board of directors can effect the dismissal of a derivative action without substantive judicial review").

123. Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 117, at 723.

124. *See supra* note 23.

because most or all of any recovery would go to higher priority claimants, shareholders lose much of their incentive to promote and participate in derivative litigation.[125] To the extent shareholders do play at least a minor role in a given suit, they are therefore likely to be indifferent (and perhaps even resistant) in the bankruptcy context.[126]

Second, and more importantly, the plaintiffs' attorneys who often are the real parties in interest also find bankruptcy to be an inhospitable climate for pursuing derivative litigation. The most obvious problem from the attorneys' perspective is their significant loss of control over the suit in bankruptcy. Because the corporation is a nominal defendant in the action[127] (and usually an indemnitor of the defendant directors), and because derivative litigation is seen as a potential disruption to the directors' management of the corporation, bankruptcy courts sometimes subject an ongoing suit to the automatic stay, even if the defendant directors have not themselves filed for bankruptcy.[128] Derivative attorneys must then justify both the litigation and their fee arrangements to a potentially skeptical bankruptcy judge.[129] If a trustee has been appointed, derivative attorneys also run the risk of losing control of the suit to the trustee.[130]

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125. The analysis in the text focuses on state law derivative litigation. One might expect shareholders to have a greater incentive to pursue federal securities actions if their interest in such an action were characterized as a claim against the debtor, thus giving each shareholder a higher priority, creditor status to the extent of her interest in the action. Bankruptcy Code § 510(b) precludes this, however, by providing that securities claims must be given the same priority as the shareholder's stock. 11 U.S.C. § 510(b) (1988).

126. Shareholders might use their control of a derivative suit strategically in an effort to extract concessions in connection with a reorganization plan. *Cf.* David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 508 (1992) (observing that shareholders use their right to compel a shareholders' meeting opportunistically as a bargaining tool). Because of the likelihood that a derivative suit will fail in bankruptcy, however, the threat is of limited value to shareholders.

127. *See* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 369, at 1080 (3d ed. 1983) (noting that the corporation "is brought into the litigation as a nominal party defendant because of its failure to enforce the claim in its own right").

128. *Compare* Zenith Labs., Inc. v. Sinay (*In re* Zenith Labs., Inc.), 104 B.R. 659, 664 (Bankr. D.N.J. 1989) (arguing that shareholder class action proceedings should be permitted because they are "consistent with the broader goals of bankruptcy in facilitating creditor compensation and ensuring equitable distribution of the debtor's assets) *with* American Imaging Serv., Inc. v. Eagle-Picher Indus. (*In re* Eagle-Picher Indus.), 963 F.2d 855, 858-62 (6th Cir. 1992) (affirming the automatic stay of actions against non-debtor officers) *and* Circle K Corp. v. Marks (*In re* Circle K Corp.), 121 B.R. 257, 261-62 (Bankr. D. Ariz. 1990) (holding that the debtor corporation was entitled to a stay of securities fraud litigation against it and its former officers).

129. Bankruptcy Code § 327 requires bankruptcy court approval of any attorney who will be rendering services on behalf of the estate. 11 U.S.C. § 327(e) (1988). Bankruptcy Code § 330 conditions payment of the attorney on court approval after notice and a hearing. *Id.* § 330(a).

130. Because all of a corporation's assets become part of the bankruptcy estate when it files for bankruptcy, *id.* § 541 (1988 & Supp. IV 1992), and because the trustee is charged with overseeing the estate, *id.* § 1106, the trustee arguably has the right to take charge of any existing derivative litigation on behalf of the estate. *See In re* Penn Cent. Sec. Litig., 335 F. Supp. 1026 (E.D. Pa. 1971) (allowing the trustee to take exclusive control of the securities litigation).

Finally, a debtor's managers can stall and in many cases ensure the eventual death of any pending or potential derivative action against them. To delay an existing action, managers not only can engage in ordinary stonewalling tactics such as thwarting requests for information, but, as noted above, they also may persuade a bankruptcy court to enjoin the action in order to prevent it from interfering with the reorganization process.[131] Far more dramatically, an action can be killed by making it a condition of any overall reorganization plan. While dismissal of a derivative or similar action in connection with the confirmation of a reorganization plan is somewhat problematic as a statutory matter,[132] bankruptcy courts have upheld releases of a debtor's officers and directors in several major Chapter 11 cases.[133]

The status of derivative litigation in bankruptcy stems at least in part from vestigialization. State courts and lawmakers have little reason to focus on insolvency-related issues and, as a result, have not considered how the mechanism should be adjusted for application in the context of a collectivized insolvency proceeding. Yet bankruptcy, as the discussion above suggests, by its very nature tends to stymie derivative suits. So long as bankruptcy courts simply incorporate the derivative procedures of state law into bankruptcy, the procedures will continue to prove ineffective.

Interestingly, some bankruptcy courts have partially adjusted their procedures in derivative actions to account for the bankruptcy context. As noted above, shareholders make poor derivative plaintiffs when a firm is in bankruptcy because insolvency seriously undermines their decision-making incentives. An obvious solution to this problem would be to give control of derivative suits to the unsecured creditors' committee after a firm files for bankruptcy relief.[134] Because unsecured creditors, unlike

131. *See supra* notes 128-29 and accompanying text.

132. *See* 11 U.S.C. § 524(e) (1988) (providing that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt").

133. *See* Menard-Sanford v. Mabey (*In re* A.H. Robins, Inc.), 880 F.2d 694, 702 (4th Cir. 1989) (holding that § 524(e) does not limit the equitable power of the bankruptcy court to enjoin a suit against another entity); Trans World Airlines, Inc. v. Texaco, Inc. (*In re* Texaco, Inc.), 92 B.R. 38 (S.D.N.Y. 1988) (dismissing appeal to sever the release of certain claims in the settlement agreement as moot); *see also* RICHARD B. SOBOL, BENDING THE LAW: THE STORY OF THE DALKON SHIELD BANKRUPTCY 275 (1991) (describing the release of A.H. Robins's insiders in connection with the corporation's plan of reorganization).

134. An interesting question raised in several cases is whether an *individual* creditor should be permitted to bring a derivative action on behalf of all creditors, just as an individual shareholder may sue outside of bankruptcy. For various reasons, such suits have not been allowed to go forward. *See, e.g.*, Larsen v. Munoz (*In re* Munoz), 111 B.R. 928, 931 (D. Colo. 1990) (holding that the creditor had no standing in a suit to avoid a fraudulent conveyance by the debtor because the creditor failed to seek permission to pursue the claim from either the trustee or the bankruptcy court); *In re* V. Savino Oil & Heating Co., 91 B.R. 655, 657 (Bankr. E.D.N.Y. 1988) (ruling that an individual creditor would not be granted authority to pursue a fraudulent conveyance action because the creditor had not demonstrated that the trustee or creditors' committee would fail to zealously prosecute the action).

shareholders, are likely to receive most or all of the benefit of each additional dollar brought into the estate,[135] the unsecured creditors' committee has much better incentives with respect to the decision whether or not to pursue a given derivative suit.[136]

A few courts have taken precisely this approach and have permitted a creditors' committee to initiate derivative litigation on behalf of the debtor during the course of a bankruptcy case.[137] In the most important and most frequently cited of the cases, the Fifth Circuit permitted the unsecured creditors' committee of a nonprofit corporation to bring a derivative action against the firm's directors.[138] The court's analysis, as construed and applied in subsequent decisions, has given rise to a four-part test for determining whether the creditors' committee has standing in a given case.[139]

Arguably, this is the appropriate result, so long as a creditors' committee has been appointed, because the creditors' committee better reflects the interests of creditors as a whole. Yet the effectiveness of creditor committee representation is in many respects suspect. *See* Skeel, *supra* note 126, at 525-30.

135. Skeel, *supra* note 126, at 511.

136. This is not to say that the incentives of unsecured creditors' committees are perfect. If a firm is solvent or only marginally insolvent, for instance, creditors may be excessively conservative decision makers. *See* George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 910-12 (1993); Lin, *supra* note 99, at 1489-91. But because most Chapter 11 debtors are insolvent, as between shareholders and unsecured creditors, creditors are a significantly better choice as decisionmakers.

Another means of increasing the effectiveness of the derivative suit mechanism in bankruptcy might be to hold an auction for the litigation, at least in some circumstances. An auction offers benefits outside of bankruptcy, such as eliminating the conflict between attorneys and the derivative plaintiffs. Coffee, *Unfaithful Champion*, *supra* note 117, at 78; Macey & Miller, *supra* note 117, at 109; Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 NW. U. L. REV. 423, 423-24 (1993). There are benefits inside of bankruptcy as well: The winning bidder would not have the same mixed motives as the debtor-in-possession or a creditors' committee. For example, the winning bidder would not have an incentive to accept a compromise settlement in return for concessions on other reorganization issues. On the other hand, adding another constituency to the negotiation process would further complicate the already cumbersome process of developing a reorganization plan. *See* Steven W. Rhodes, *Eight Statutory Causes of Delay and Expense in Chapter 11 Bankruptcy Cases*, 67 AM. BANKR. L.J. 287, 294 (describing the reorganization process as "complex").

137. *See, e.g.*, Louisiana World Exposition v. Federal Ins. Co., 858 F.2d 233, 239 (5th Cir. 1988); Official Comm. of Unsecured Creditors v. Mellon Bank (*In re* Allegheny Int'l, Inc.), 93 B.R. 903, 905 (Bankr. W.D. Pa. 1988) (both permitting a creditors' committee to bring a derivative suit when the shareholders had no incentive to bring one).

138. *Louisiana World Exposition*, 858 F.2d at 252-53. The court made clear that creditors would be deemed to have standing only if they would have had standing under state law; it then constructed an elaborate explanation of how creditors could meet this requirement. *Id.* at 237-44. Interestingly, subsequent courts have tended to ignore the peculiar facts of the case—in particular, the fact that because the corporation did not have any shareholders, its directors arguably would have been immune from suit if the creditors' committee were found to lack standing. *Id.* at 241.

139. The requirements, which largely track the prerequisites shareholders must satisfy in order to pursue derivative litigation outside of bankruptcy, are as follows: 1) a colorable claim exists; 2) demand was made on the debtor; 3) the debtor unjustifiably refused to bring suit; and 4) the committee obtains leave of the court. *See* Craig H. Averch, *The Ability to Assert Claims on Behalf of the Debtor: Does*

On first inspection, the willingness of the courts to authorize creditors' committees to pursue derivative litigation in some cases seems to suggest that bankruptcy courts are likely to solve the vestigialization problem on their own. Unfortunately, however, the promising judicial developments in this area appear to be largely an accident of the particular context of many of the suits, rather than the beginning of a solution. Most of the creditors' committee standing cases are preference and fraudulent conveyance actions—actions that already belong to creditors both within and outside of bankruptcy.[140] In the most common case, a creditors' committee seeks to avoid a preference or fraudulent conveyance after the debtor has failed to do so, often because the beneficiary of the transfer was an insider.[141] In such a case, there is little question as to the interest of the creditors in the cause of action. It is largely because of the association with these "true" creditors' actions that some courts have authorized a creditors' committee to pursue derivative litigation that would be brought by shareholders outside of bankruptcy.

Moreover, the willingness of the bankruptcy courts to authorize creditors' committee standing in cases filed after the commencement of bankruptcy addresses only a small part of the derivative suit problem.[142] The more difficult and arguably more important issue is what should happen to derivative suits filed prior to bankruptcy. These suits are the ones that are most likely to die in bankruptcy.

How might these cases be integrated into bankruptcy if the effects of vestigialization did not thwart the development of a coherent framework for their resolution in this context? The analysis above suggests that the courts

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a Creditor Have a Leg to Stand On?, 96 COMM. L.J. 115 (1991) (summarizing cases that address when a creditor or a statutory creditors' committee may bring a derivative action); *see also In re* First Capital Holding Corp., 146 B.R. 7, 12-13 (Bankr. C.D. Cal. 1992) (concluding that the creditors' committee need not make a demand if it would be futile).

140. *See, e.g.*, Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1363 (5th Cir. 1986) (granting standing to the creditors' committee in a preference claim); Unsecured Creditors Comm. v. Farmers Sav. Bank (*In re* Toledo Equip. Co.), 35 B.R. 315, 320 (Bankr. N.D. Ohio 1983) (denying standing to the creditors' committee in a preference claim); *In re* V. Savino Oil & Heating Co., 91 B.R. 655, 656 (Bankr. E.D.N.Y. 1988) (denying standing in a fraudulent transfer claim). Courts that find standing in these contexts often look to Bankruptcy Code § 1109(b), which gives a creditors' committee broad authority to act as a party in interest in the bankruptcy case. *See, e.g.*, *Coral Petroleum*, 797 F.2d at 1363 (citing 11 U.S.C. § 1109(b) (1988)).

141. *See, e.g.*, *Coral Petroleum*, 797 F.2d at 1354 (describing the challenged preferential transfer as one made by the debtor to a single creditor).

142. Even the *Louisiana World Exposition* framework is subject to question in some respects. Most importantly, it gives the bankruptcy court the final say regarding whether creditors' committee litigation should go forward. In this respect, it resembles Delaware's much-maligned standard for deciding whether to uphold a special litigation committee's recommendation that derivative litigation be terminated outside of bankruptcy. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 789 (Del. 1981) (holding that the second prong of the two-prong standard authorizes a court to substitute its own business judgment for that of the committee).

should continue to substitute creditors for shareholders as plaintiffs.[143] One possible concern with this conclusion warrants attention, however. While substituting creditors as the plaintiffs is an attractive solution once the corporation has filed for bankruptcy, we must also consider the effects of such a rule outside of the bankruptcy context. In particular, might shareholders be less likely to file and pursue a derivative suit outside of bankruptcy if they would lose control of the suit in the event a bankruptcy petition were filed? Arguably not, at least in the context of publicly held corporations, given that the attorneys, rather than the shareholders themselves, are the ones who tend to have the most at stake.[144]

Yet what about the attorneys? Unless the derivative suit procedures either compensate the attorneys for their efforts at searching for and bringing a derivative suit outside of bankruptcy,[145] or allow the attorneys to retain control of the suit even after a substitution of plaintiffs, the specter of bankruptcy will continue to chill—as it currently does—the efforts of the constituency whose activities ultimately are most essential to the success of the derivative suit mechanism. It is important to allow the attorneys to retain control, or otherwise to compensate them, even in those cases where a trustee has been appointed. While a trustee's incentives to pursue litigation in an appropriate case are far superior to those of the defendant directors, the chilling effect of wresting the case from the attorneys who filed it must be taken into account.[146]

To be sure, some commentators are sufficiently skeptical about the efficacy of derivative litigation that they might question—as a normative matter—whether lawmakers should undertake to adjust the derivative procedures to better account for the effects of bankruptcy.[147] However

143. *See supra* notes 124-39 and accompanying text.

144. *See* Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 117, at 683-84 (noting the limited role and stake of shareholders in derivative suits); *see also supra* text accompanying note 117.

145. Coffee points to the difficulty of compensating the first attorney to bring a derivative suit for her search costs as one of the major impediments to the auction proposal. Coffee, *Understanding the Plaintiff's Attorney*, *supra* note 117, at 691-93. *But see* Macey & Miller, *supra* note 117, at 114-15 (suggesting that courts could develop ways of compensating the attorney who initiates the derivative litigation, such as allowing the attorney to seek compensation in quantum meruit).

146. One obvious solution would be to substitute the trustee for shareholders as the plaintiffs but to permit the existing attorneys to pursue the case. While a creditors' committee arguably has better incentives as a plaintiff than the trustee does, the trustee also has a direct financial interest in the outcome of the case. *See* 11 U.S.C. § 326 (1988) (providing that a trustee's compensation is based on the amount of distributions made in the case).

147. One could argue that the costs of derivative suits exceed their value to a firm, and thus, the ineffectiveness of the derivative suit mechanism in bankruptcy is laudable, rather than problematic. *See* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 277-83 (1986) (questioning whether shareholder litigation has any significant effect on stock value); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991) (interpreting an empirical study as showing that shareholder litigation is largely ineffectual). This normative

persuasive this perspective may be, the important point for present purposes is that skepticism about derivative litigation clearly does not explain the failure of state and federal lawmakers to develop procedures that are effective in the bankruptcy context.[148]

Once again, the vestigializing effects of the artificial separation of corporate law and bankruptcy provide a far more convincing explanation of the confused status of derivative suit doctrine in the bankruptcy context. State lawmakers have had little reason to focus on the issues described above because the issues almost always arise in the context of a federal bankruptcy case, rather than under state law.[149] Yet, because of their tendency to look to state law for guidance, federal lawmakers also have neglected these tricky questions. In consequence, the derivative suit mechanism not only fails to work effectively in bankruptcy, but its failure also exacerbates the underinvestment problem that plagues derivative litigation outside of bankruptcy.

C. *Corporate Voting Rights in Bankruptcy*

Vestigialization also helps to explain the courts' treatment of the question whether shareholders should be permitted to call a shareholders' meeting for the purpose of ousting corporate directors. Bankruptcy courts have relied even more heavily on state law in addressing this issue than they have in dealing with derivative suits, perhaps in part because of the absence of complicating factors like those present in the derivative suit context, such as the existence of related causes of action that provide for creditor rather than shareholder standing and the involvement of additional parties (including initiating attorneys).[150]

Outside of bankruptcy, the shareholders' right to hold a meeting for the election of directors is seen as integral to shareholder suffrage and, as a result, is nearly absolute. Under Delaware law, for instance, shareholders may petition the chancery court to summarily compel a shareholders' meeting if none has been held for a period of thirteen months after the last meeting.[151] Delaware courts typically grant the shareholders' request unless extraordinary circumstances militate against allowing shareholders to hold their annual meeting.[152]

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argument is comparable in some respects to Bowers's article suggesting that preference laws in bankruptcy are inefficient. *See supra* note 96 and accompanying text.

148. *Cf.* 8 SEC REPORT, *supra* note 62, at 31-32 (criticizing an analogous situation in the equity receivership context, where receivers, who often were friendly with management, frequently failed to bring lawsuits against former directors).

149. *See supra* note 102 and accompanying text.

150. Much of the analysis that follows is drawn from Skeel, *supra* note 126.

151. DEL. CODE ANN. tit. 8, § 211(c) (1991).

152. *See, e.g.*, Coaxial Communications, Inc. v. CNA Fin. Corp., 367 A.2d 994, 997-98 (Del. 1976) (holding that the lower court did not abuse its discretion in ruling that the pendency of a

Bankruptcy courts have developed a test that closely parallels state courts' treatments of shareholder voting outside of bankruptcy. In *In re Johns-Manville Corp.*,[153] the most recent circuit court decision on this issue, the court held that requests for a shareholders' meeting should be honored unless holding a meeting would constitute "clear abuse" and would cause "irreparable harm" to the corporation.[154] The apparent reasoning is that because state courts authorize shareholders' meetings except in unusual circumstances, bankruptcy courts should do the same.[155]

The problem with simply incorporating states' treatment of this issue into the bankruptcy context is, once again, that the state law on this issue has not been developed with insolvent corporations in mind. States have not adequately grappled with the question of who should vote (and under what conditions) in the context of a collectivized insolvency procedure because most insolvent corporations ultimately file for bankruptcy.[156] Moreover, the vestigialized state insolvency procedures that do exist contemplate a timely sale or other disposition of the corporation rather than continued operation of the company in an insolvency mode for several years, as has become common in Chapter 11.[157] As a result, the question whether shareholders can hold an annual meeting is unlikely to arise, even for those few corporations that invoke state collectivized insolvency procedures.

If the artificial separation between corporate law and bankruptcy did not prevent state lawmakers and courts from focusing on corporate voting in the insolvency context, one suspects that state law would provide for the application of a significantly different rule in the event a collectivized insolvency procedure is invoked. While the shareholders of a healthy

proceeding in another jurisdiction was not a basis to stay the shareholders' meeting); Algeran, Inc. v. Connolly, No. CIV.A.6557, 1981 WL 15073 (Del. Ch. Oct. 5, 1981) (holding that the unavailability of financial information needed for proxy solicitation does not justify the failure to hold a meeting). The few occasions where Delaware courts have enjoined a meeting have tended to involve actions by shareholders to enjoin a meeting due to fraud or other improprieties in the election process. *See, e.g.*, Campbell v. Loew's Inc., 134 A.2d 565 (Del. Ch. 1957) (staying a shareholders' meeting until the court could resolve allegations of improper spending by some directors).

153. Manville Corp. v. Equity Sec. Holders Comm., 801 F.2d 60 (2d Cir. 1986).

154. *Id.* at 68; *see also infra* note 160 and accompanying text.

155. Other courts have gone much further than *In re Johns-Manville Corp.* in their solicitude for the state law perspective on this issue. In Lionel Corp. v. Committee of Equity Sec. Holders (*In re* Lionel Corp.), 30 B.R. 327 (Bankr. S.D.N.Y. 1983), for instance, the court—applying the state law preliminary injunction standard instead of the *In re Johns-Manville Corp.* standard—allowed the equity committee's request for a meeting to go forward in the Delaware chancery court, after first making clear that there was "nothing in the record that demonstrates how the reorganization is going to be impeded here by the holding of an annual meeting." *Id.* at 330. The chancery court granted the meeting request. Committee of Equity Sec. Holders v. Lionel Corp., N.Y. L.J., June 28, 1983, at 6.

156. *See supra* note 102 and accompanying text.

157. *See* JAMES J. WHITE, BANKRUPTCY AND CREDITORS' RIGHTS 23-24 (1985) (describing state receivership and assignment-for-the-benefit-of-creditors procedures).

corporation are its residual claimants and, as a result, have better decisionmaking incentives than any other constituency, shareholders are far less dependable after the firm has encountered financial difficulties. The shareholders of an insolvent corporation have little to lose if they gamble with the firm's assets, and much to gain.[158] In view of this, shareholders arguably should not be permitted to continue to choose the firm's directors and to vote on other important decisions once the corporation has entered bankruptcy.[159]

At first glance, a "clear abuse" or other similar standard might appear to be flexible enough to account for the skewing effect that bankruptcy has on shareholders' decisionmaking incentives. Given shareholders' questionable motives, for instance, bankruptcy courts could be sensitive to the fact that a shareholders' request for a meeting is more likely to be abusive in bankruptcy than it would if the corporation were fully solvent. In fact, courts do appear to appreciate the possibility of abuse in some cases, as evidenced by several courts' decisions to deny a meeting request.[160]

The problem with this approach is that it seems to imply that although their incentives are somewhat skewed in bankruptcy, shareholders are still better decisionmakers than any other constituency. Yet, once a corporation becomes significantly insolvent, the reality is different. In light of this,

158. Skeel, *supra* note 126, at 485-86.

159. In the absence of bankruptcy, the argument for shifting authority to unsecured creditors is more tenuous, both because insolvency may be difficult to determine and because creditors arguably can contract for voting rights if they desire such rights. *Cf.* Lin, *supra* note 99, at 1504 (discussing creditors' ability to contract for voting rights). By contrast, Chapter 11 debtors usually are insolvent, and it is not clear whether creditors' contractual voting rights would be respected in bankruptcy. *Cf.* 11 U.S.C. § 362 (1988) (providing for an automatic stay of creditors' efforts to seek repayment).

160. *See, e.g.*, *In re* Potter Instrument Co., 593 F.2d 470, 475 (2d Cir. 1979) (noting that a shareholders' meeting would sound a "death knell" for the corporation); *In re* Heck's, Inc., 112 B.R. 775, 801 (Bankr. S.D. W. Va. 1990) (refusing to permit a shareholders' meeting during confirmation process), *aff'd in part, rev'd in part on other grounds*, 151 B.R. 739 (Bankr. S.D. W. Va. 1992); Manville Corp. v. Equity Sec. Holders Comm. (*In re* Johns-Manville Corp.), 66 B.R. 517, 534 (Bankr. S.D.N.Y. 1986) (stating that permitting a shareholders' meeting poses "a serious threat and real jeopardy" to the reorganization); *see also* Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 696-99 (1993) (finding that requests for shareholders' meetings were denied in two of the four cases studied). Although the Second Circuit decision in *In re Johns-Manville Corp.* reversed the lower court's initial denial of the equity committee's request to pursue a meeting, the court suggested in a footnote that, had Johns-Manville been insolvent, shareholders would have lost their interest in electing directors. Manville Corp. v. Equity Sec. Holders Comm., 801 F.2d 60, 65 n.6 (2d Cir. 1986). While commentators have criticized the *In re Johns-Manville Corp.* dicta, my analysis suggests that it be adopted, and in fact, expanded to a blanket rule in all cases. For examples of the criticisms of the *In re Johns-Manville Corp.* dicta, see Gerber, *supra* note 79, at 353-54 (noting that in Chapter 11, insolvency does not bar shareholders from voting on a plan or retaining an interest in a reorganized company and arguing that shareholders thus retain an interest in the governance of the company); Thomas G. Kelch, *Shareholder Control Rights in Bankruptcy: Disassembling the Withering Mirage of Corporate Democracy*, 52 MD. L. REV. 264, 295 & n.175 (1993) (noting that the court's opinion in footnote six "is by no means a universal view" and contrasting the competing arguments).

unsecured creditors should replace shareholders as the voters in the event that a corporation has filed for bankruptcy.[161] Because bankruptcy courts have looked to state voting rules for guidance as to the appropriate contours of corporate voting in bankruptcy, and the state provisions have only solvent corporations in mind, bankruptcy courts have not even considered the possibility of adopting such a rule. Instead, bankruptcy courts have attempted to maneuver within the confines of a state voting framework that makes sense for a healthy corporation but is far more problematic in bankruptcy.

D. *Summary and Implications*

Recognition of the vestigialization caused by the separation between corporate law and corporate bankruptcy has important implications for our assessment of the proper relationship between bankruptcy and state law. As noted earlier, courts and commentators have long taken as an article of faith that bankruptcy courts should incorporate state law wherever possible.[162] While this principle is perhaps most familiar as the central tenet of the first comprehensive theory of bankruptcy law, the creditors' bargain model,[163] it has informed the analyses of many other courts and commentators as well.[164]

At the least, the perverse effects of vestigialization suggest that bankruptcy courts should scrutinize state law more carefully before simply transplanting it to the bankruptcy context. In many areas, such as foreclosure provisions and the priority scheme set forth in Article Nine of the

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161. Skeel, *supra* note 126, at 511. Another approach might be to eliminate directorial voting altogether in Chapter 11 and to require any constituency that is dissatisfied with the directors' performance to seek the appointment of a trustee pursuant to Bankruptcy Code § 1104. 11 U.S.C. § 1104 (1988). Because appointing a trustee is a dramatic step and is undesirable in many contexts where a change in management might make sense, this approach seems less attractive than vesting voting authority in unsecured creditors, but it would improve on the current regime by removing the vote from shareholders.

162. *See supra* notes 79-81 and accompanying text.

163. *See* David G. Carlson, *Bankruptcy and the Creditors' Bargain*, 61 U. CIN. L. REV. 453, 460 (1992). Bankruptcy theorists have recently criticized the creditors' bargain theory on various grounds, arguing, for instance, that the parties themselves could solve the collective action problems that the theory cites as evidence of the need for a bankruptcy regime. *See, e.g.*, Adler, *supra* note 1, at 313-15 (challenging the assumption that there is a collective action problem); Randal C. Picker, *Security Interests, Misbehavior and Common Pools*, 59 U. CHI. L. REV. 645, 647-48 (1992) (criticizing recent scholars for ignoring creditor misbehavior); Schwartz, *supra* note 1, at 600-02 (arguing that the holdout problem is not unavoidable). But however problematic Chapter 11 itself appears to be, the existence of some sort of collectivized proceeding clearly is necessary. *See* Skeel, *supra* note 1, at 492-93 (arguing that the threat of strategic behavior by creditors and the risk of undesirable and unnecessary dismemberment of corporations that are more valuable as going concerns make eliminating bankruptcy an unattractive alternative). In consequence, many of the insights of the creditors' bargain theory remain fully valid, at least as a starting point.

164. *See supra* note 79.

UCC,[165] states have clearly legislated with default and insolvency in mind. As a result, it is perfectly appropriate to replicate the effects of these provisions in bankruptcy. In contrast, state law is a poor source of guidance in areas such as those discussed above, in which state lawmakers have paid little or no attention to the ramifications of insolvency for laws developed with solvent corporations in mind.

The analysis of this Part raises an intriguing question: If charter competition encourages states to regulate corporate law in a relatively efficient fashion, as appears to be the case,[166] and if a corporation and its various constituencies have an incentive to contract around inefficient rules, why have state lawmakers or the parties themselves not eliminated the effects of vestigialization? With respect to state legislation in an area like state preference law, the answer is simply that federal law has occupied the field.[167] So long as a substantial majority of insolvent corporations wind up in bankruptcy, rather than invoking state collectivized insolvency procedures, states do not have sufficient incentive to focus on their preference provisions. Only if states were to develop collectivized insolvency provisions that were effective enough to persuade an appreciable number of corporations to forego Chapter 11 would they have reason to focus upon their preference laws.[168]

165. *See, e.g.*, U.C.C. §§ 9-301, -312, -501 to -507 (1991).

166. *See infra* Part IV.

167. In contrast to state lawmakers, Congress has relatively few structural incentives to pass efficient laws because it has a relative monopoly over the laws it administers. While the possibility that corporations might move overseas if Congress regulates them poorly could create competitive pressures somewhat like those faced by the states in their competition with one another, the effects are far more attenuated. For a more detailed consideration of this issue, see *infra* Part IV.

168. Given states' incentives to make their corporate law as attractive to corporations as possible, it is somewhat surprising that none has developed an effective state corporate bankruptcy regime as an alternative to Chapter 11. Perhaps states have stayed out of this area because of a perception either that Chapter 11 preempts any effort by the states to cover analogous ground or that other legal obstacles preclude the enactment of an effective state insolvency regime. Yet the Supreme Court has been extremely hesitant to strike down state regulation on preemption grounds. *See* David S. Welkowitz, *Preemption, Extraterritoriality, and the Problem of State Antidilution Laws*, 67 TUL. L. REV. 1, 9-11 (1992). Other legal barriers may be more problematic, at least in the absence of enactment by Congress of enabling legislation that clears some of the hurdles, but most do not appear to be completely prohibitive. *See infra* Part V. Another possible disincentive is the administrative costs of handling corporate insolvency issues in state court, although these costs would be at least partially offset by the increased attractiveness of the state to corporations and by the legal fees that would be generated for local lawyers.

One recent exception to states' continued neglect of insolvency issues is Delaware's enactment of a new insolvency provision designed to enable an insolvent corporation to better deal with future liability problems. DEL. CODE ANN. tit. 8, §§ 280-282 (1991) (prescribing procedures that permit a corporation facing unknown future claims to formulate a court-approved plan to satisfy these potential future claimants in connection with a statutory dissolution); *see also In re* RegO Co., 623 A.2d 92, 105-11 (Del. Ch. 1992) (requiring that a statutory dissolution plan not discriminate against unknown future claimants in favor of known claimants). Even if the states fail to overhaul fully their insolvency regimes, they might increasingly follow Delaware's lead and adopt partial alternatives to Chapter 11.

In other contexts, the enduring effects of vestigialization are more puzzling. Because bankruptcy courts look to state law in corporate governance areas such as derivative suits and corporate voting, we might expect that states would have greater reason to develop insolvency-sensitive rules for these contexts. There are several possible explanations for their failure to do so. First, as with state preference law, the most obvious occasion for enacting such rules would be in connection with an overhaul of state insolvency regulation. Yet, as just noted, states have not taken this step. Second, the explanation may lie in interest-group politics.[169] The application of interest-group theory to the case at hand begins with the recognition that managers may prefer the existing, inefficient laws and therefore have no incentive to seek reform.[170] So long as the existence of a federal bankruptcy system ensures relatively uniform laws on the issues in question, no state is penalized by the markets for failing to legislate. While other constituencies, who are harmed by the inefficiencies, might prefer that states adjust their corporation statutes to account for the effects of insolvency, none is likely to have enough at stake to warrant sustained lobbying for a special set of insolvency rules.[171]

Some of the inefficiencies that state lawmaking fails to curb could be addressed contractually by the parties themselves, but private ordering also appears to be only a partial solution. The parties might try to devise their own preference regulation or provide for shareholders to replace creditors as voters under specified conditions, but collective action problems would limit the efficacy of these approaches in some contexts, as would the

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169. In its simplest form, interest group, or public choice analysis posits that concentrated, well-organized groups frequently benefit in the legislative process at the expense of more diffuse ones, even if the diffuse group has more at stake overall. *See* Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 48 Q.J. ECON. 371, 380 (1983) (asserting that the effectiveness of any group in the political process will be determined by its efficiency in relation to other groups); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 211-12 (1976) (noting that a small group with a large per capita stake may dominate over a large group with more diffuse interests); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 349 (1974) (noting that "the geographic concentration of the people who would benefit from favorable regulation is an important element because a legislator will exert greater efforts on behalf of a voter bloc large enough to" have a material effect on the outcome of an election).

170. *See* Adler, *supra* note 1, at 344-45 (arguing that managers would oppose any reform that might threaten their discretion).

171. Shareholders are the most obvious beneficiaries of any provision that improves the efficiency of corporate law. While the increasing concentration of ownership by institutional shareholders has made this group less diffuse than traditionally has been the case, the financial impact of the provisions affected by vestigialization may not be great enough to capture institutional shareholders' attention (especially when, as with the corporate voting issue, a rule that is inefficient *ex ante* appears to benefit shareholders *ex post*). These shareholders would be more likely to become involved if all of bankruptcy were being reformed. *Cf.* Skeel, *supra* note 1, at 496-97 (noting that institutional investors own significant percentages of publicly held corporations and have taken an active role in opposing antitakeover provisions and other measures that they see as inconsistent with their interests).

awkwardness of bargaining for insolvency procedures at a time when insolvency is likely to be seen as a remote risk.[172] Perhaps more importantly, it is questionable whether any of these contractual approaches could be implemented in Chapter 11 because a private preference law would conflict with the mandatory strictures of Chapter 11[173] and private voting or derivative suit rules might be neutralized by bankruptcy's automatic stay.[174]

While each of these explanations is a plausible account of the persistence of the inefficiencies created by the separation between corporate law and corporate bankruptcy, none offers a complete explanation. In many respects, vestigialization remains a puzzle. What seems clear, however, is that these inefficiencies do exist, and that each is a legacy of the decision to federalize corporate bankruptcy.

IV. The Case for a Unitary Law of Corporations

As Part III pointed out, the artificial separation between state corporate law and federal corporate bankruptcy has created inefficiencies in both domains. These inefficiencies are not likely to be confined to the specific doctrines we have considered. Rather, each of the doctrines reflects a problem that is more pervasive in scope.

Having described the vestigialization caused by the separation between corporate law and corporate bankruptcy, I turn in this Part to the question of what we might do to address these problems. I begin in subpart IV(A) by considering several possible responses to vestigialization. I argue that responses preserving the existing order—such as relying on the uniform laws process—probably would not eliminate the problem and that the most effective solution would be to shift authority over corporate bankruptcy to the states. It is doubtful whether the effects of vestigialization are themselves sufficiently debilitating to warrant so sweeping a reform. Yet, in addition to addressing vestigialization concerns, shifting authority over corporate bankruptcy to the states would have more far-reaching beneficial

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172. *See* Skeel, *supra* note 1, at 481-82.

173. The power of the trustee to reject executory contracts entered into prior to the filing of a bankruptcy petition would be one impediment to a contractual approach. *See* 11 U.S.C. § 365(a) (1988); *cf.* Adler, *supra* note 1, at 322-23 (describing nonstatutory impediments to parties' ability to adopt an alternative to the Chapter 11 bankruptcy regime). It is interesting to note in this regard that the stakeholders who have sought to bargain for directorial representation and other governance protections in recent years have typically been constituencies, such as unions and major lenders, that have overcome their collective action problems. *See, e.g.*, John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1523-28 (1990) (describing proposals in bargaining with unions to provide employee representation on the board of a major airline).

174. *See* 11 U.S.C. § 362(a) (1988) (halting any effort to assess or collect on a claim against the debtor).

effects. In particular, this Part suggests that such a reform would improve both existing corporate bankruptcy law and state regulation of general corporation law.

After describing the advantages of expanding state authority over corporate law to include corporate bankruptcy, I discuss some of the potential objections to state regulation of corporate bankruptcy, including the administrative burden this reform would impose on states (and its implications for state lawmaking), the danger of arbitrary and inconsistent laws, and the possibility of systematic inefficiencies in state lawmaking in some contexts. The last of these objections, in particular, may be a basis for concern. Rather than undermining the case for state lawmaking authority, however, my analysis suggests, at most, that Congress should retain control over a few bankruptcy issues.

A. *Why the States Would Do It Better*

1. The Superior Responsiveness of State Lawmaking.—The historical analysis in Part II suggests that the most obvious solution to the problems created by the separation between corporate law and corporate bankruptcy would be to shift authority over corporate bankruptcy back to the states. I argue in this subpart that state regulation of corporate bankruptcy is in fact the most promising response to the inefficiencies of the current regime. Yet it is important to keep in mind that shifting corporate bankruptcy to the states would require a significant change from the current federally regulated and administered bankruptcy system. I therefore begin by considering two alternative approaches.

a. Supplementing the current regime with uniform laws.—One way to address the vestigialization problem might be for an independent organization such as the National Conference of Commissioners on Uniform State Laws to propose specific provisions that close the gap between state corporation law and the federal Bankruptcy Code.[175] The uniform laws process has proven extremely effective in contexts such as child

175. Other organizations such as the American Law Institute or the American Bar Association might also be candidates for undertaking a project of this sort. The American Law Institute recently published a proposed framework for corporate law. *See* AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1992). *See generally* Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984 (1993) (criticizing the mandatory framework of the ALI's *Principles of Corporate Governance*). Similarly, the American Bar Association, which also is involved with the National Conference in the uniform laws process, developed both the Model Business Corporation Act and Revised Model Business Corporation Act. *See* MODEL BUSINESS CORP. ACT (1979); REVISED MODEL BUSINESS CORP. ACT (1991). While these organizations differ in some respects in their approaches, much of the discussion below is applicable to each. I focus on the uniform laws process to simplify the analysis.

custody, where the uniform law has helped states to coordinate their resolution of choice-of-law issues.[176] As we have seen, uniform fraudulent conveyance laws also have seen significant success, at least as measured by the number of states that have adopted them.[177] Perhaps the most important attraction of the uniform laws process for present purposes is that the commissioners could limit their attention to those provisions with respect to which the separation between corporate law and bankruptcy is likely to cause problems. In all other respects, the state regulation of corporate law and Congress's control of Chapter 11 could be left as it is.

Despite the obvious virtues of the uniform laws process, it is nevertheless subject to several limitations that would significantly undermine its usefulness in this context. The first limitation of uniform laws stems from the premium placed by the Conference on developing laws that will be adopted by every state.[178] The need to satisfy the concerns of every state not only makes the drafting process cumbersome and time consuming; it also may stifle innovation because states are discouraged from altering the terms of any uniform provision they adopt.[179] The chilling effect that a uniform law has on innovation is particularly problematic in the corporation law context, given the constantly changing business environment against which the laws play out.

The effort to accommodate the interests of as many states as possible also affects the initial content of the provisions proposed by the Conference. Much of the Uniform Commercial Code, for instance, is vague and open-ended, a tendency that can be traced as much to the concern for uniformity as to the vision of its principal drafters.[180] The effect of open-ended standards, in addition to increasing litigation, is to shift the responsibility for further defining the terms to the courts.[181] In many contexts, courts are well equipped to perform this task—particularly with respect to rules that are relatively timeless or that benefit from slow evolution.

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176. *See* Larry E. Ribstein & Bruce H. Kobayashi, A Theory of Uniform Laws 29 (1993) (unpublished manuscript, on file with the *Texas Law Review*) (observing that the Uniform Child Custody Jurisdiction Act has been adopted by 52 states and territories). *See generally* UNIF. CHILD CUSTODY JURISDICTION ACT, 9 U.L.A. 123 (1968).

177. *See supra* notes 107-08 and accompanying text; *see also infra* Appendix B (listing those states that have adopted these uniform laws).

178. *See* Allison Dunham, *A History of the National Conference of Commissioners on Uniform State Laws*, 30 LAW & CONTEMP. PROBS. 233, 249 (1965) (noting that the commissioners are completely committed to uniformity). Because neither the ALI nor the ABA is as focused on achieving blanket adoption as the Conference is, this critique is less applicable to these institutions. But the need to reach global consensus within each of these groups may have comparable effects.

179. Ribstein & Kobayashi, *supra* note 176, at 13.

180. *See* Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures: With Application to Commercial Law* (1994) (unpublished manuscript).

181. *See* John A. Sebert, Jr., *Remedies Under Article Two of the Uniform Commercial Code: An Agenda for Review*, 130 U. PA. L. REV. 360, 362-63 (1981).

Courts are less effective in areas that require frequent innovation, however.[182] Further, the uncertainty costs created by the need for judicial clarification are likely to increase the expense of implementing the rule.[183]

A second problem with the uniform laws process is that it suffers from an inevitable incompleteness. Because this approach would not eliminate the separation between state corporate law and federal corporate bankruptcy, the tensions that gave rise to vestigialization in the first instance would remain. In other words, the uniform laws process might patch over the effects of vestigialization, but it would not fully cure the problem.

b. *Federalizing all of corporate law.*—Another solution might be to federalize general corporation law. Assertion by Congress of control over general corporation law would create a uniform federal law of corporations and thus eliminate the split between corporation law and corporate bankruptcy. Moreover, this approach would accord with the calls by some commentators to federalize much of corporate law.[184]

Several problems seriously undermine the attractiveness of the federalization solution. One shortcoming of federalizing all of corporation law is Congress's general unresponsiveness as a lawmaker in many contexts—that is, its failure to adjust existing legislation to keep pace with legal and economic developments.[185] The likelihood that Congress would fail to adapt corporation law to changing conditions stems both from the political forces that frequently tie its hands and, more importantly, from the absence of competitive pressures of the sort that prod states to pay relatively close attention to the contours of their corporation law.[186] It is not accidental that, prior to the 1978 Bankruptcy Code, Congress had never succeeded in passing significant bankruptcy legislation except in times of national

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182. *See id.* (suggesting that legislation is required to effect substantial innovations and modifications in the UCC).

183. *See* Ribstein & Kobayashi, *supra* note 176, at 13 n.52 (noting that an increase in the courts' role creates uncertainty and reduces clarity, thus undermining the basic function of uniform laws).

184. This view, at least in its modern conception, is usually seen as having originated with Professor William Cary. *See* Cary, *supra* note 6. Subsequent articles in this vein include the following: Richard W. Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976); Donald G. Schwartz, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L.J. 71 (1972); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947 (1990).

185. In some contexts, such as tax regulation, Congress is particularly active as a lawmaker. But Congress's attentiveness in this context may stem less from an interest in improving the contours of existing law than from other motives. *See* Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913, 934-42 (1987) (advancing an explanation of recent tax changes based on the politicians' extractions of personal and political benefits).

186. *See infra* subsection IV(A)(1)(c).

financial crisis.[187] While delegation of authority to an agency would diminish this problem, the agency would be subject to similar limitations as a lawmaker.[188]

A closely analogous problem with federalizing corporation law is that it would shift a substantial administrative burden to the federal government. As even the most avid advocates of federalizing much of corporation law acknowledge, Congress is poorly situated to attend to the myriad of details that issuing charters for corporations (and regulating them thereafter) entails.[189]

Finally, even if federalization of corporation law were more attractive from a normative perspective, such a step would be unlikely as a practical matter. Because some states derive substantial financial benefits from their chartering business, they would fiercely contest any proposal to fully federalize corporation law.[190] Given the deeply embedded tradition of state sovereignty over corporation law, the states could probably thwart any effort at complete federalization.[191]

c. *State control over corporate bankruptcy*.—We come now to the proposal suggested at the outset of this Part: Control over corporate bankruptcy should be shifted from Congress to the states. Why is this proposal superior to any of the alternatives discussed above?

From a historical perspective, vesting control over corporate bankruptcy in the states has the attraction, as compared to federalizing all of corporate law, of more fully respecting the unique role that the states have played in the development of corporations.[192] In addition, like federalizing

187. *See* WARREN, *supra* note 21, at 9.

188. Congress's delegation of securities regulation to the Securities and Exchange Commission provides an illustration of these problems. *See generally* Securities Act of 1933, ch. 38, tit. I, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77 a-bbbb (1988)). Like Congress itself, for instance, the SEC has a monopoly over the issues it governs and thus does not face the kinds of competitive pressures that influence state lawmaking in the corporate area. For similar reasons, the SEC also has an incentive to focus more on expanding its role than on optimal regulation. *See* Jonathan Macey, *The SEC Dinosaur Expands Its Turf*, WALL ST. J., Jan. 29, 1992, at A12 (opining that advances in securities markets that have eliminated the need for the SEC have led that agency to seek new jurisdiction in order to justify its own continued existence).

189. *See, e.g.*, WILLIAM L. CARY & MELVIN A. EISENBERG, CORPORATIONS: CASES AND MATERIALS 99 (6th ed. unabr. 1988) (noting that a proposal for a federal incorporation law was rejected because, inter alia, "statutory corporation law contains an enormous amount of minor details . . . which are unlikely to capture the interest of Congress").

190. *See infra* note 196 and accompanying text.

191. Notice that this observation might also prove true with respect to a move (which I propose in the text that follows) to shift corporate bankruptcy to the states. Although federal lawmakers have less of a vested interest in retaining authority in this area than state lawmakers have with respect to corporate law, other interest groups—particularly federal bankruptcy judges—might fight strenuously against reform.

192. *See supra* Part II.

corporate law, and unlike tinkering with the current regime, de-federalizing corporate bankruptcy would eliminate the source of the vestigialization problem. Nevertheless, it is questionable whether vestigialization, by itself, is sufficiently debilitating to justify so dramatic a reform as shifting control over corporate bankruptcy to the states. If only vestigialization were at issue, a patchwork solution such as the uniform laws process might prove adequate. But state regulation of corporate bankruptcy offers other, ultimately more important, advantages in addition to the elimination of vestigialization.

The most important advantage of shifting authority to the states, as compared to the current federal bankruptcy regime, is that state lawmakers are far more responsive than Congress and, as a result, will amend and update their laws in a more timely fashion. This is not so much because state lawmakers do not face the same political or legislative volume pressures that Congress does;[193] rather, states are responsive in the corporate law context because, unlike Congress, they must compete to attract corporations to their jurisdiction. Because a corporation ordinarily can incorporate wherever it chooses, and because the internal affairs doctrine ensures that the law of the state of incorporation will govern the relationship between shareholders and management,[194] corporations have an incentive (both when they first incorporate and thereafter as they consider whether to change their state of incorporation) to shop for the state with the most attractive laws.[195] For their part, states care deeply about the choice that a corporation makes because a state derives substantial financial benefits from the corporations it charters.[196] One way that states can,

193. While the state legislative workload may frequently be less onerous than Congress's, many state legislators serve in the legislature on a part-time basis. Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 133 (1987). Thus, they too are under significant time pressures. Moreover, the states may in some contexts be subject to more troubling pressures than federal lawmakers. For instance, the relative absence of consumer and other interest group activity at the state level may make it easier for the managers of an important local corporation to obtain special treatment. *See id.* at 134-36 (discussing the absence of political interest from nonbusiness groups in Connecticut's takeover legislation and the support shown by Aetna and other local business interests).

194. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 & cmt. a (1988).

195. In a recent article, Bill Carney provides a more precise typology of the conditions that make charter competition possible. In addition to adherence to the internal affairs doctrine, these conditions include: the ability to cross borders and to conduct business in foreign jurisdictions (that is, jurisdictions other than the place of incorporation); absence of adverse consequences when a corporation does business elsewhere; and universal access to the laws of competing jurisdictions. William J. Carney, Federalism and Corporate Law: Conditions for Optimal Development 16-17, 25-26 (1993) (unpublished manuscript, on file with the *Texas Law Review*). As Carney points out, the absence of several of these requirements in Europe diminishes the likelihood that comparable charter competition will develop in the European Community. *See id.* at 20-21 (discussing the European conflict-of-laws rule that "the governing law of the corporation is that of the jurisdiction where the corporation has its principal offices").

196. The most direct benefit to states is the yearly franchise tax that they charge corporations incorporated within their borders; in addition, states also receive indirect benefits such as the legal fees

and do, attempt to attract new and foreign corporations, as well as to discourage existing corporations from relocating, is to demonstrate a responsiveness to corporate concerns as they arise.

Delaware serves as the most prominent example of this phenomenon. In addition to the other advantages Delaware offers—such as the expertise of specialized courts[197] and a constitutional system that discourages adverse changes in its corporation law[198]—the responsiveness of Delaware's legislature to emerging corporate issues has played a significant role in its success in the competition for charters.[199] In a study of the relative responsiveness of the states, Roberta Romano found not only that Delaware was more responsive than any other state legislature, but also that there tended to be a strong correlation between a state's responsiveness and its success in attracting corporate charters.[200]

To be sure, state lawmakers' superior responsiveness is a virtue only if states respond by improving, rather than undermining, existing law. One group of commentators, the so-called race-for-the-bottom theorists, has argued that because managers choose a firm's state of incorporation, states compete for corporate charters by passing laws that favor managers at the expense of shareholders.[201] These theorists view charter competition as malignant and have called for greater federalization to counteract what they see as its troubling effects.[202]

Yet, as a succession of race-for-the-top theorists have pointed out, market pressures are likely to counteract any tendency states might otherwise have to underappreciate shareholders' interests.[203] If a corporation

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earned by local attorneys as a result of a corporation's presence in the state. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 240-41 (1985).

197. Delaware's Court of Chancery has no jurisdiction over tort and criminal cases. DEL. CONST. art. IV, § 1. Thus, corporate cases will not be held up by the usual backlog of criminal and tort cases and will be heard by a court that focuses on business issues.

198. *See id.* art. IX, § 1 (requiring any revision of corporate law be supported by a two-thirds supermajority vote).

199. Because of the significant revenue Delaware derives from corporate franchise fees, Delaware is effectively committed to remaining responsive—and not to acting opportunistically—in the future. *See* Romano, *supra* note 196, at 242. This commitment to responsiveness further increases Delaware's attractiveness as a state of incorporation. *Id.* at 240-42.

200. *Id.* at 238-40.

201. *See, e.g.*, Cary, *supra* note 6, at 685 ("Delaware, . . . seeking revenue and proud of its leadership in the race for incorporation, must please management . . . ."); Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 557 (1984) ("A state legislature that attempts to restrict in any significant way the power of managers . . . soon finds that corporations will . . . 'flee' to another state . . . .").

202. *See, e.g.*, Cary, *supra* note 6, at 665, 700-01 (characterizing charter competition as "contagious" and calling for federal standards to ensure minimum levels of corporate responsibility); Schwartz, *supra* note 201, at 586 (calling for federalization to end negative charter competition).

203. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 416-17 (1983) (noting that many institutional investors have voted against management-proposed charter amendments "designed to deter potential bidders from making a tender offer" because

incorporates in a state whose laws diminish shareholder wealth, the corporation will be forced to pay a greater price to raise capital and will be similarly disadvantaged in the product market, as compared to corporations that choose a state with superior laws. The corporation's diminished ability to compete also brings the market for corporate control into play, because new managers could improve the fortunes of the firm simply by taking the firm over and reincorporating it in another state.[204] The reality of these market pressures strongly suggests that corporations will seek, and states therefore have an incentive to provide, laws that maximize the value of the firm.[205]

It is important to emphasize that the claim here is not that charter competition has led to completely efficient state laws. On the contrary, various factors will prevent state lawmakers from developing fully efficient laws. To the extent reincorporation is costly,[206] legislators in a state such as Delaware may be able, at least to a limited extent, to satisfy interest group pressures at the expense of developing a more fully efficient legal regime.[207] Yet the strong tendency is for states to enact more, rather

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of the tendency of such amendments to reduce shareholder welfare); Winter, *supra* note 6, at 276-77 (citing the "satisfied or nonexistent" demand by shareholders for the inclusion of specific "reforms" in individual corporate charters as evidence that such reforms in the form of state legislation may not be necessary).

204. *See* Winter, *supra* note 6, at 264-66 (describing the market for management control as an important economic constraint on corporate management). The disappearance of the takeover market in recent years has reduced its effectiveness as a disciplining device. Yet other market forces remain fully in effect, and the takeover market is likely to be compensated, at least in part, by other market mechanisms. *See* J. Mark Ramseyer, *Columbian Cartel Launches Bid for Japanese Firms*, 102 YALE L.J. 2005, 2018-20 (1993) (pointing out the importance of market and organizational incentives other than the market for management control, such as the labor and capital markets and the markets for products and services).

205. While many commentators, including myself, agree that efficiency should be the primary goal of a corporate law framework (and that state lawmaking tends in this direction), there is some debate as to what characteristics an efficient law is likely to have. *Compare* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15 (1991) (suggesting that efficient law consists of default provisions consistent with the terms most parties would choose through their own bargaining) *with* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1554-55 (1989) (arguing that some mandatory rules that prevent bargaining may be efficient) *and* Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1397-1400 (1992) (reviewing EASTERBROOK & FISCHEL, *supra*) (contending that states should enact penalty defaults to encourage more bargaining).

206. *See* Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 724 (1987) (postulating that reincorporation is costly enough to hamper the effectiveness of charter competition). Not all commentators agree that reincorporation is costly. Bernie Black contends that corporations can change states at a comparatively low cost. Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 586-88 (1990). While Black offers persuasive evidence as to the relatively low direct costs of reincorporation, at least for large, publicly held firms, he does not account for the indirect costs of such a move—such as its adverse signalling effects.

207. Macey and Miller suggest, for example, that Delaware may enact litigation-increasing rules, which benefit the local bar. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 504-05 (1987).

than less, efficient laws.[208] As discussed earlier, Congress has far less of an incentive to enact similarly efficient laws due to the absence of the sort of competitive pressures that shape state corporate law.[209]

The analysis thus far relies upon state lawmakers' effectiveness in regulating corporate law as evidence that states would also be better regulators of corporate bankruptcy than Congress. This reliance obviously rests on an important assumption: The competitive pressures that ensure generally efficient corporation laws will have a similarly desirable impact on a state corporate bankruptcy regime. Is this assumption warranted? Some might contend that it is not for either of two reasons. First, one could argue that the same incentives that encourage efficiency in states' enactments of general corporation law would have perverse effects in the bankruptcy context. In particular, given the competitive pressure to satisfy managers and to maximize *shareholders'* wealth, states might enact bankruptcy provisions that inefficiently divert wealth from a firm's creditors to its shareholders.[210]

At least for consensual creditors, however, this argument seems misplaced. The same kinds of market pressures that force states to enact efficient general corporation laws should prevent them from diverting wealth to shareholders in bankruptcy. If a state enacted a shareholder-oriented bankruptcy law of this sort, the windfall to shareholders would be short-lived. Creditors would simply charge more for credit so that, *ex ante*, a corporation and its shareholders would not benefit at all from its inefficient law. In fact, such a law almost certainly would diminish shareholder wealth, given the other perverse effects (such as managerial misconduct) it would generate. As a result, a state's incentive to maximize shareholder wealth is likely to lead to a bankruptcy regime that respects creditors' interests, rather than one that inefficiently diverts wealth to shareholders.[211]

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208. Another important caveat is in order. The analysis in the text does not suggest that states will tend to enact efficient laws in all areas. State lawmaking is likely be efficient only when, as in corporate law, states are subject to competitive pressures.

209. *See supra* notes 193-205 and accompanying text.

210. *See* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1489, 1489-90 (1992) ("[I]f a corporate law rule can be designed to transfer value from creditors to shareholders, then shareholders may well find the rule attractive even if it is inefficient . . . .").

211. Because nonconsensual creditors such as tort claimants cannot protect themselves by contract, states could and arguably do pass laws that favor other constituencies at the tort creditors' expense. The general rule that shareholders are given limited liability with respect to all claims against a corporation, including tort claims, is one example of this. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Liability for Corporate Torts*, 100 YALE L.J. 1879, 1916-19 (1991) (criticizing the justification of limited liability for tort claims as a means of ensuring efficient capital investments in corporations). *But see* Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 392-405 (1992) (questioning the efficacy of an unlimited

A second concern with respect to state enactment of corporate bankruptcy laws is that such laws would not fall within the internal affairs doctrine and thus courts might not look to the bankruptcy law provided by a corporation's state of incorporation. As described above, the internal affairs doctrine ensures that the law of the state of incorporation will regulate issues relating to the internal governance of a corporation.[212] If choice of law were based not on the state of incorporation, but on some other factor such as the firm's principal place of business, corporate managers would lose much of their incentive to shop for the optimal corporation law regime, and the competition for charters would break down.[213] As a result, states would have far less pressure to enact efficient corporate law legislation.[214] Thus, the internal affairs doctrine is a crucial component of the competitive process I have described.

Even with respect to issues relating directly to relationships among the shareholders and managers of a firm, the internal affairs doctrine is not absolute. Courts sometimes apply law other than that of the state of incorporation with respect to issues sufficiently far removed from the structure and governance procedures of the firm as to implicate considerations such as agency or tort doctrine.[215] Yet the internal affairs doctrine is sufficiently broad and applies to enough of the core issues involving a corporation[216] that managers have an enormous incentive to choose the firm's state of incorporation carefully.

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liability approach in light of arbitrage effects on stock prices). Yet Congress has not proven any more solicitous of tort creditors' interests than the states, as evidenced by the low priority tort creditors are given in bankruptcy. *See* 11 U.S.C. § 507(a) (1988) (giving no special priority to tort claims).

212. *See supra* notes 194-95 and accompanying text.

213. The applicability in much of Europe of the "real seat" doctrine—a rule that bases choice of law on the jurisdiction where a corporation has its principal place of business—appears to be a major impediment to the development of effective charter competition in the European Community. Carney, *supra* note 195, at 20-21.

214. States still might use their corporation laws as a way to attract corporations to the state. The state's law would apply, however, only if the state was also a corporation's principal place of business. Because numerous other factors such as location and access to necessary raw materials contribute to a corporation's decision where to locate its principal place of business, the role of charter competition would be much more attenuated. *See generally* ROBERT W. HAIGH, INVESTMENT STRATEGIES AND THE PLANT-LOCATION DECISION: FOREIGN COMPANIES IN THE UNITED STATES 32-68 (1987) (detailing the key factors companies use in determining plant location).

215. *See, e.g.*, Lee v. Jenkins Bros., 268 F.2d 357, 363-64 (2d Cir.) (applying the law of the state where the promise allegedly was made rather than the law of the state of incorporation to determine whether the director had apparent authority to bind the corporation), *cert. denied*, 361 U.S. 913 (1959); Francis v. United Jersey Bank, 432 A.2d 814, 820 (N.J. 1981) (applying New Jersey law rather than the law of the state of incorporation in holding a corporate director personally liable for misappropriation of funds because all significant relationships of the parties were with New Jersey).

216. The *Restatement (Second)* suggests that the law of the state of incorporation should apply to any issue involving relations among shareholders, directors, and officers. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 302 cmt. a., 303-07, 309 (1988). Moreover, the law of another state should not be applied except in rare circumstances. *Id.* § 302 cmt. g.

Whether this incentive and the effects of charter competition would continue to operate in the bankruptcy context is doubtful, however. The internal affairs doctrine applies only to relationships among the shareholders and managers of a corporation.[217] It does not extend to the corporation's transactions with third parties such as creditors.[218] Because much of bankruptcy addresses third-party issues of this sort, the internal affairs doctrine would not ensure the application of the bankruptcy laws of the state of incorporation. Instead, a court would apply ordinary conflict-of-laws principles to determine which state's law to apply.[219] If courts frequently looked to the bankruptcy laws of a state other than the state of incorporation, charter competition might prove far less effective in the bankruptcy context than it is for states' general corporation laws.

Despite the uncertainty as to which bankruptcy laws a court would apply, the likelihood that courts regularly would spurn the bankruptcy regime of the state of incorporation in favor of another state's law is smaller than might initially seem to be the case. Under ordinary conflict-of-laws principles, courts are directed to consider factors such as the relative interests of the states whose laws could apply, protection of the justified expectations of the parties, the policies underlying the law in question, the certainty and uniformity of the choice made, and the ease of determining which law a court should apply.[220] To be sure, if a Delaware corporation is headquartered in Illinois and does most of its business there, Illinois has a substantial interest in having its laws govern any bankruptcy involving the corporation. Yet several other, equally relevant factors favor the use of Delaware law. Applying Delaware law might better accord with the expectations of the parties, would enhance the certainty and uniformity of the choice made, and would minimize the difficulty of determining the appropriate law.[221] Thus, even aside from the theoretical advantages of extending the internal affairs doctrine to corporate bankruptcy, courts might well look to the law of the state of incorporation under ordinary conflict-of-laws principles.

Notice, in this regard, that the factors favoring the law of the state of incorporation would prove most compelling in precisely the cases where choice of law is most likely to be at issue. Small and closely held

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217. *Id.* § 302 cmt. a.

218. *Id.*

219. *See id.*

220. *Id.* § 6(2).

221. European Community law requires corporations to designate their country of registration on all correspondence and order forms. Alfred F. Conard, *The European Alternative to Uniformity in Corporation Laws*, 89 MICH. L. REV. 2150, 2171 (1991). If a state were to impose an analogous requirement in its corporate law or if corporations took such a step voluntarily, ease of discovery would weigh even more in favor of applying the law of the firm's state of incorporation.

corporations almost always incorporate in the same state in which they do all (or most) of their business.[222] Consequently, choice of law is not a serious issue if such a corporation files for bankruptcy. On the other hand, for a publicly held corporation, which may be incorporated in one state, headquartered in another, and do substantial business in a variety of locations, the choice becomes far less obvious. In these cases, the interests in uniformity and giving the parties notice of which law is likely to apply become especially important. The best way to achieve these goals—and the approach that many courts might adopt—is to apply the law of the state of incorporation.

The possibility that some courts would apply a different state's law cannot be dismissed. Yet the residual uncertainty as to a court's likely approach to choice of law could be reduced in either of two ways. First, the corporation could insert a choice-of-law clause in its contracts, providing that the law of the state of incorporation will apply in the event that bankruptcy is filed.[223] Second, and more simply, Congress could eliminate the problem altogether by passing a choice-of-law statute requiring state courts to apply the bankruptcy laws of the state of incorporation. As long as any legislation aimed at shifting corporate bankruptcy authority to the states included such a provision, charter competition would shape state bankruptcy law in much the same fashion as it currently shapes general corporation law.

A final issue concerning charter competition in the bankruptcy context also warrants mention. In view of the low probability of bankruptcy for any given corporation, it might appear that differences in states' bankruptcy laws might not have enough significance for any given corporation to influence its choice of state of incorporation. Yet even if the corporation itself does not anticipate bankruptcy, creditors (such as banks) that deal with many debtors know that a certain number will wind up in bankruptcy. Creditors therefore have good reason to care which bankruptcy regime will apply in the event of insolvency and should adjust their credit prices accordingly. As a result, a debtor that is interested in minimizing its credit costs must take states' bankruptcy laws into account.

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222. Incorporating out of state can be costly to a closely held corporation because a firm may be required to pay both a franchise tax to the state of incorporation and a tax for doing business in the local state. CARY & EISENBERG, *supra* note 189, at 98. A local corporation's attorney may also prefer to operate under local law. *Id.*

223. Moreover, such a clause could, if the parties wished, not only provide for application of the law of the state of incorporation, but could also require that any bankruptcy case be brought in that forum. *Cf.* Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 590-97 (1991) (enforcing a forum-selection clause despite its small print and the inconvenience of the forum to the plaintiffs). There are two limitations on this solution: It would only work in the event the corporation made sure that all of its contracts included such a clause, and it might not be effective for corporations that have a significant number of nonconsensual creditors.

d. Implications for current bankruptcy theory.—The analysis above demonstrates how shifting control over corporate bankruptcy to the states would address the vestigializing effects of current law more effectively than any alternative solution. While a concern about elimination of the vestigialization problem that exists under current law would not by itself justify shifting authority over all of corporate law to the states, this is only one of the benefits of such a reform. The same qualities that make state law a better response to vestigialization also suggest that state lawmakers would do a better job in regulating corporate bankruptcy as a whole than Congress has done. Given the states' responsiveness in the corporate law area, for example, they almost certainly would adjust and update existing corporate bankruptcy laws more regularly and efficiently than Congress does.

Notice that this analysis has important implications for the debate whether Chapter 11 should be abolished. The current disaffection with Chapter 11 stems from a widespread belief that the bankruptcy process is inordinately time-consuming, costly, and ineffective.[224] In view of these problems, commentators have speculated whether Chapter 11 should be replaced by a mandatory auction regime[225] and have suggested that the parties should at least have the option of implementing a different regime, such as one that provides for automatic cancellation of a firm's stock on default,[226] or of choosing from among a menu of bankruptcy options.[227]

If states were responsible for bankruptcy, their interest in maximizing their overall corporation-related revenues quite possibly would cause them to develop a bankruptcy regime that obviated many or all of the problems of Chapter 11. We might therefore expect to see some states experiment with different approaches to insolvency, including perhaps variations on those approaches that have recently been proposed by commentators. One of the central themes of the proposed alternatives to Chapter 11 is that corporations should be given far more flexibility to alter existing bankruptcy rules by contract if they so choose.[228] Given the states' track records in the context of general incorporation statutes, we would expect to see at least a move in this direction: toward bankruptcy regimes that replace the mandatory rules of the existing federal bankruptcy framework with statutes that leave significant room for private ordering.[229]

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224. Skeel, *supra* note 1, at 472-73.

225. *See, e.g.*, Baird, *supra* note 1, at 641-47 (suggesting that it is unclear whether losses from such a switch would approximate any gains).

226. *See, e.g.*, Adler, *supra* note 1, at 323-33 (describing a "Chameleon Equity" regime).

227. *E.g.*, Rasmussen, *supra* note 1, at 55-68.

228. *See, e.g.*, Bowers, *supra* note 2, at 1786 ("[T]he best solution is to permit firms to choose which [bankruptcy] regime they feel is least costly.").

229. *See* EASTERBROOK & FISCHEL, *supra* note 205, at 34-36 (noting that state corporation law consists largely of default rules that can be varied by contract). The question whether the

2. *Eliminating the Bankruptcy Externality in State Lawmaking.*—In addition to addressing the vestigialization problem and improving the quality of corporate bankruptcy laws as a whole, shifting authority over corporate bankruptcy arguably has yet another attraction. Much as it addresses the vestigialization effect on state lawmaking, shifting bankruptcy authority to the states might also cause the states to improve the efficiency of those provisions that apply to healthy, solvent corporations.

To appreciate how this might be so, recall the race-for-the-top theory concerning the effects of state charter competition and its contention that market pressures will cause managers to search for, and states to provide, laws that are far more efficient than might otherwise be the case.[230] Despite nearly two decades of debate, neither these theorists nor the race-for-the-bottom theorists (nor commentators subscribing to intermediate positions) have considered the effect of the federalization of corporate bankruptcy on the state chartering process. Most importantly, Chapter 11 acts as a substantial federal subsidy to the states. Congress not only has assumed lawmaking responsibility in the bankruptcy context; it also has established federal bankruptcy courts for bankruptcy cases. In fiscal year 1992, Congress allocated nearly $389 million to cover the costs of running the bankruptcy system.[231] Because the federal government currently shoulders all of these costs, states need not take the portion that relates to corporate bankruptcy into account in their corporation law statutes.[232] As a result of this externality, state lawmakers are likely to develop laws that, at least on the margin, create too great a likelihood that bankruptcy will in fact occur.[233]

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predominantly enabling nature of state corporate law is, or should be, supplemented by mandatory rules was the subject of a widely cited symposium. Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

230. *See supra* notes 203-05 and accompanying text.

231. Telephone Interview with Evan Tausch, Supervisory Budget Policy Analyst, Administrative Office of the United States Courts (June 21, 1993). Of the total allocation of $388,632,000, $40,419,000 consisted of salaries and benefits paid to bankruptcy judges, and $219,013,000 comprised salaries and benefits paid to the administrative staff. *Id.*

232. If the cost in each state were identical (which obviously is not the case), the administrative costs of bankruptcy would be $7,772,640 per state. To give a rough assessment of the impact on state corporate lawmaking, one would need to reduce this number to reflect the amount that is incurred in connection with individual bankruptcy cases, given that the proposal in the text would shift authority over only corporate (and municipal) bankruptcy to the states. A substantial majority of the bankruptcy cases filed involve individuals rather than corporations, but on the other hand, personal bankruptcy cases are likely to be less complicated and thus less costly from an administrative standpoint than those involving corporations. In 1992, for instance, 265,577 Chapter 13 bankruptcy cases were filed by individuals, as compared to 22,634 Chapter 11 reorganization cases and 681,663 Chapter 7 liquidations. The Chapter 7 liquidations include filings by both individuals and corporations. ADMINISTRATIVE OFFICE OF THE U.S. COURTS, BANKRUPTCY STATISTICAL INFORMATION 2 (rev. ed. 1993).

233. This is not to say that state law will completely fail to account for the possibility of bankruptcy, because a state will lose the franchise tax revenue it receives from a corporation if the

The effects of the bankruptcy externality on current state corporate law should not be overstated. To appreciate this, consider the erosion of capital requirements and state law restrictions on the circumstances under which a corporation may make dividends.[234] By themselves, these developments could make bankruptcy more likely because they eliminate one of the checks on the ability of managers to run a firm in an excessively risky fashion. Creditors, however, have compensated for the loss of these protections by imposing dividend limitations by contract.[235] To the extent creditors can also address the limitations of state regulation in other areas by contract, and in doing so counteract the inefficiencies of the background regime, the practical effect of any flaws in state corporation laws is likely to be less significant than might initially appear to be the case. In these contexts, the true costs of the externality may therefore consist of the costs to firms of devising a better protection by contract, together with the risk that some parties will fail to protect themselves in this fashion.

In sum, while shifting authority over corporate bankruptcy to the states would not completely eliminate the bankruptcy externality, it would impel states to pay more attention to the consequences of bankruptcy in developing the provisions that apply to currently healthy corporations.

B. *Possible Problems with State Control over Corporate Bankruptcy*

In the previous subpart, I attempted to demonstrate the extent to which state authorship of both corporate law and corporate bankruptcy could improve the current regime. The proposal is subject to several possible objections, however. First, in addition to changing the locus of regulation, transferring authority over corporate bankruptcy to the states also means shifting the expense of running the bankruptcy system to the states. A second concern is that the states might replace the present uniform framework with a maze of arbitrary and inconsistent laws. Third, despite the virtues of state regulation of corporate law discussed above, state

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corporation files for bankruptcy and eventually liquidates. But in general, states have far less reason to take bankruptcy into account than they would if they bore its full costs. Another caveat is that even if states regulated corporate bankruptcy, they would internalize the costs of bankruptcy only if corporations filed their bankruptcy petitions in the state of incorporation rather than in another state. This seems likely to be the case. In addition to the likelihood that local corporations will file for bankruptcy in their state of incorporation, *see supra* note 222 and accompanying text, the applicability of a charter state's law might give multistate corporations further incentive to file in that state, much as parties often bring actions relating to Delaware corporations in Delaware.

234. *See generally* BAYLESS MANNING & JAMES J. HANKS, JR., A CONCISE TEXTBOOK ON LEGAL CAPITAL (3d ed. 1990) (discussing the decreases in regulation of corporate capital requirements and its effect on creditors).

235. *See* Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 122-23 (1979) (describing typical contractual covenants imposed in bonds to limit risky behavior).

lawmakers appear to have questionable decisionmaking incentives in several areas of corporate law. The presence of these same poor incentives in bankruptcy law may raise doubts concerning how effectively the states would regulate corporate bankruptcy. I address these objections in the following sections.

1. The Impact of Reform on State Judicial Systems.—The shifting of authority over corporate bankruptcy to the states would add numerous new cases to a state's judicial system. Some might therefore object that, however attractive this proposal appears in theory, it would impose too great a burden on states.[236] Removing the subsidy currently provided by the federal bankruptcy system obviously would prove costly to the states, but this ultimately is not an appropriate basis for abandoning it.

First, forcing states to bear the judicial costs of bankruptcy is the only obvious means of obtaining the benefits of state lawmaking discussed above.[237] Second, it is important to keep in mind that the proposal calls for state control over only corporate bankruptcy. Congress need not also cede its authority over personal bankruptcy to the states; as discussed in Part I, one can argue that the special cognitive problems that individuals face, which help to explain the "fresh start" policy underlying Chapter 13, are sufficiently universal to justify the enactment of a single national framework for bankruptcies involving individuals.[238] Thus, a state's share of the total bankruptcy cost would not be crippling,[239] and retention by Congress of its authority over personal bankruptcy would significantly lower this cost.

This is not to say that the increased costs shouldered by the states would be trivial. The states clearly would be required to bear significant additional administrative costs if they assumed control over corporate bankruptcy.[240] The already clogged courthouses in many states also are

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236. As noted earlier, the cost of administering the entire bankruptcy system in fiscal year 1992, including both corporate and personal bankruptcy cases, was roughly $389 million. *See supra* note 231.

237. *See supra* sections IV(A)(3)-(4).

238. *See* Jackson, *supra* note 8, at 1437-38 (justifying federal bankruptcy guidelines for individuals).

239. Much of the cost of the bankruptcy system is financed with the filing fees paid by bankruptcy debtors. Luize E. Zubrow, *Creditors with Unclean Hands at the Bar of the Bankruptcy Court: A Proposal for Legislative Reform*, 58 N.Y.U. L. REV. 1383, 1397 n.55 (1983). Absent these fees, the burden of running a bankruptcy system would be far greater than it currently is.

240. As a result, the states most likely to oppose the reform would be those states that do not tend to attract many corporations—because assuming control over corporate bankruptcy would generate relatively few identifiable revenues to offset the costs to these states. On the other hand, the costs to these states might be lower because they would have a smaller caseload and because their citizens already subsidize a share of the federal bankruptcy expense.

grounds for concern.[241] If states did not appoint sufficient new judges and staff to accommodate the additional caseload, the bankruptcy process could suffer as a result. Yet the increased caseload might actually have a salutary effect. If state courts dealt both with general corporation law issues and with corporate bankruptcy, states that handle a high volume of corporate issues might follow Delaware's lead in developing specialized business courts. Judges in such states would become particularly expert in corporate matters, as Delaware's judiciary has, and thus would improve the overall quality of judicial decisionmaking in the corporate context.[242]

2. *The Danger of Arbitrary and Inconsistent Laws.*—As discussed in Part II, opponents of state bankruptcy laws traditionally have insisted that state lawmaking would produce a morass of arbitrary and inconsistent bankruptcy laws.[243] As a result, state laws would appear to impose huge deadweight costs such as the costs to creditors of familiarizing themselves with multiple bankruptcy laws.[244] While scattered and inconsistent state laws may well have posed problems in the late eighteenth century when the Constitution was enacted, erratic variations seem far less likely today. Vast changes in interstate commerce have greatly reduced the importance of regional differences and the parochial concerns that accounted for much of the inconsistency.[245] As noted earlier, states' performance in the corporate law context reinforces the suggestion that problems of this sort have largely disappeared. Rather than varying wildly from state to state, state corporation law statutes are remarkably uniform in most important respects.[246] Nor would we wish for complete uniformity; the states'

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241. To give a single example, many cases take as long as five to six years to come to trial in Chicago and other major cities. Milo Geyelin & Vindu P. Goel, *Lawyers Push for Special Business Courts*, WALL ST. J., Oct. 31, 1990, at B4 (quoting Thomas D. Allen, partner at Wildman, Harrold, Allen & Dixon in Chicago, Illinois).

242. For instance, Pennsylvania and several other states have considered establishing special business courts in recent years. *See id.* at B4. Assumption of authority over corporate bankruptcy might induce states to go forward with such plans.

243. *See supra* note 60.

244. From this perspective, a uniformly applicable law is a public good, the value of which will be lost if the states are permitted to adopt differing approaches. Jeffrey Gordon has used a similar argument to justify mandatory state laws. Gordon, *supra* note 205, at 1564-67 (explaining the Uncertainty Hypothesis, which argues that allowing parties to contract around a given rule would introduce uncertainty as to the parameters of the rule). *Contra* Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1603-04 (1989) (questioning whether such blurring does occur and suggesting that frequent deviation from a given rule indicates that the parties prefer a different standard).

245. *See* Romano, *supra* note 196, at 235, 233-35 (analogizing desirable state bankruptcy laws to technological innovation in commerce in order to point out that individual states must "follow the leader" or else "lose incorporations at the margin").

246. *See id.* at 233-42 (noting that many states enact similar statutes within very short time periods when corporations deem such laws desirable).

ability to adjust their corporate codes is a crucial virtue of state authority in this area.[247]

Notice that the states' inconsistent treatment of state preference laws does not undermine this argument. As discussed at length above, the inconsistencies in areas such as preference law stem from the states' lack of sufficient incentive to focus on these issues—a direct result of the federalization of corporate bankruptcy.[248] Were states the ones regulating all aspects of corporation law, neglect and arbitrary variation would disappear in this context.

3. *The Inefficiencies Lurking Within State Lawmaking.*—The third objection to state regulation of corporate bankruptcy argues that although the competition for corporate charters seems to cause states to enact general corporation laws superior to those of Congress, the tendency of the states toward efficiency breaks down in some contexts. In the analysis that follows, I consider why, and under what conditions, states may systematically enact inefficient general corporation law provisions. After the identification of these problem areas in the following subsections, I will explore their bankruptcy implications in some detail in subpart IV(C).

a. *Management entrenchment and widespread enactment of state antitakeover statutes.*—The near-universal recognition that state lawmaking in the corporate law context may sometimes favor management entrenchment over efficient lawmaking can be traced, in large part, to the recent experience with state antitakeover statutes. Despite the negative impact these statutes have on shareholder wealth,[249] state after state enacted some

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247. *See* Baysinger & Butler, *supra* note 92, at 191 (concluding that competition among the states with respect to corporate governance law produces a variety of rules from which firms can select in order to maximize their returns).

248. *See supra* subpart III(A).

249. The empirical research to date has tended to find either significant negative effects as a result of takeover legislation or the absence of a statistically significant effect. *See, e.g.*, Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 J. FIN. ECON. 291 (1989) (observing a small but statistically significant decrease in stock prices of corporations incorporated or headquartered in states that passed second-generation takeover laws); Donald G. Margotta et al., *An Analysis of the Stock Price Effect of the 1986 Ohio Takeover Legislation*, 6 J.L. ECON. & ORG. 235 (1990) (finding no statistically significant effect of the Ohio antitakeover law on stock prices); Michael Ryngaert & Jeffry M. Nutter, *Shareholder Wealth Effects of the Ohio Antitakeover Law*, 4 J.L. ECON. & ORG. 373 (1988) (finding that share prices at Ohio firms dropped 2% after passage of Ohio's antitakeover law in 1986). Studies finding that the Delaware provision did not have a statistically significant impact on stock price are fully consistent with the view that Delaware enacted a relatively lax provision because market pressures discouraged it from adopting a stringent antitakeover law. Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 857-58 (1993) (citing John S. Jahera & William N. Pugh, *State Takeover Legislation: The Case of Delaware*, 7 J.L. ECON. & ORG. 410 (1991)).

form of antitakeover provision in the 1980s.[250] Now that the dust has settled, even the most outspoken proponents of the race-for-the-top theory have been forced to acknowledge that states do not always enact optimal corporate laws.[251]

Why were these inefficient antitakeover provisions passed by so many states, and what are the implications for the contention that charter competition will lead to efficient bankruptcy law? The obvious starting point in this assessment is the one, not surprising, empirical clue that we have: The constituency that plays the greatest role in lobbying for antitakeover laws is managers—often the managers of a single, locally prominent corporation.[252] How could these managers have succeeded in obtaining favorable, but inefficient, protection from takeovers in the face of charter competition's theoretical constraints?

One possible explanation holds that while charter competition generally prods states toward efficiency, states can pass an inefficient, excessively management-friendly law with impunity if the law itself has the effect of impairing the market's ability to discipline managers.[253] In this view, market pressures failed to prevent states from enacting antitakeover laws because such laws neutralized the market for corporate control. It may therefore have been the chilling effect on takeovers—the most dramatic and, in some respects, the most effective market corrective—that ensured the legislative success of these laws. In its broadest incarnation, the market-impairment thesis seems to suggest that market forces are helpless to prevent any law that reduces the influence of market discipline. Yet the passage of antitakeover laws appears to have been a relatively extraordinary occurrence. The question this raises is: When is the market impairment problem likely to come into play? Or, from a slightly different perspective: Why did states prove especially susceptible to value-decreasing antitakeover laws?

The aspect of takeovers that made them special may well have been the remarkable end-game dynamic[254] they created. Managers of a firm that incorporates in a state that has enacted one or more market-impairing

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250. For a discussion of these provisions, see Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365, 373-77.

251. *See* EASTERBROOK & FISCHEL, *supra* note 205, at 218-22 (discussing the states' adoption of various antitakeover statutes and analyzing the theories that explain why states are willing to hamper tender offers).

252. Romano, *supra* note 193, at 120-25.

253. Bebchuk, *supra* note 210, at 1467-70; Gordon, *supra* note 205, at 1572 n.74.

254. Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 927-28 (1993) (defining the concept of an "end-game dynamic" as a situation where one party to a cooperative effort shifts its focus to self-preservation or self-interested actions because such a shift cannot produce a worse outcome for that party than the cooperative effort would have produced).

provisions will eventually be penalized. In the long run, managers who are protected by a particularly strict antitakeover provision will pay more for any capital they subsequently seek to raise.[255] But the managers have little incentive to focus on long-term pressures of this sort in the face of a realistic takeover threat, given that a takeover would inevitably lead to their ouster.[256]

Moreover, the end-game mentality not only seems to have altered managers' perspectives, but also may have influenced the state lawmakers who subsequently enacted the antitakeover statutes. First, state legislators ran the risk that their failure to protect an important local corporation would prompt the firm to reincorporate in another state.[257] A second, and more subtle, reason is that legislators may have feared that in the event that local corporations stayed put and were in fact acquired, the acquirer would move the company to another state.[258]

In sum, the dramatic success of antitakeover legislation has made clear that charter competition does not always prevent states from adopting inefficient corporate laws. In the antitakeover context, the market-impairing nature of the provisions and the end-game environment in which they emerged provide possible explanations of why market restraints broke down.

b. Self-dealing that fails to trigger market correction.—A second concern with state lawmaking stems from the perceived imprecision of the market discipline that encourages states to enact efficient laws. In this view, while the markets for capital, products, labor, and corporate control have a constraining influence, these forces are only effective if the provision in question has a significant adverse effect on the value of a corporation's stock.[259] Unhappily, in this view, many kinds of serious misbehavior by managers and controlling shareholders do not have a readily

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255. *See* Romano, *supra* note 249, at 858-59. If the antitakeover law is particularly draconian, the firm may suffer even more immediate consequences. *See* Leslie Wayne, *Many Companies in Pennsylvania Reject State's Takeover Protection*, N.Y. TIMES, July 20, 1990, at A1 (noting that such consequences include the mass sell-off of stock by major stockholders, a falling stock price, and a tarnished reputation).

256. Stated differently, if the probability that a manager's firm will be taken over and the manager displaced exceeds the probability that the firm's incorporation in a state that insulates managers from takeover will so impair the firm's performance as to lead to the manager's ouster, managers are likely to lobby for antitakeover legislation. This will be true despite the adverse effect antitakeover legislation has on the firm's value.

257. *See* Carney, *supra* note 195, at 53-55. The consequences of Virginia's enactment of the first antitakeover statute support this analysis, as several corporations reincorporated in Virginia to take advantage of the new law. Romano, *supra* note 196, at 246.

258. *See* Carney, *supra* note 195, at 53 (noting that Georgia's statute was passed out of concern that a major bank would be acquired by an out-of-state suitor and concluding that legislators might pass such laws in response to promise of future political support).

259. Bebchuk, *supra* note 210, at 1461.

measurable impact on stock value and, thus, may not be restrained by the market.[260]

Consider a simple example. If a manager of a corporation with net assets of $250,000,000 diverts $100,000 to herself through a self-dealing transaction, she benefits greatly at the expense of the firm; from the firm's perspective, on the other hand, the diversion may be far too small to have any real impact on the value of its stock.[261] As a result, managers will seek laws that leave room for diversions of this sort—lax laws in areas such as managerial self-dealing, usurpation of corporate opportunities, and freeze-out transactions by controlling shareholders[262]—and market forces will fail to constrain state lawmakers from satisfying managers' value-decreasing wishes.

While market discipline will inevitably be imprecise, for at least two reasons state lawmaking may be appreciably less suspect in the self-dealing context than in the antitakeover context. First, the suggestion that a manager's diversion of $100,000 has too trivial an impact on stock value to trigger market correction ignores the potentially significant indirect costs of such a diversion: Managers who divert corporate assets may also be paying more attention to covering their own footsteps than to the firm's fortunes.[263] As a result, the market is likely to react unfavorably to self-dealing even though the actual amounts diverted are insignificant.

Second, it is far less obvious (as a descriptive matter) in the self-dealing context than with antitakeover legislation that existing state law is inappropriately lax. Delaware, for instance, has authorized corporations to all but eliminate the managers' duty of care, yet it refuses to provide the same flexibility in the duty-of-loyalty context.[264] Similarly, most states require that self-interested transactions be approved by a majority of directors or shareholders or be shown to have been fair.[265] State courts frequently have required more.[266]

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260. *Id.* at 1461-67.

261. To better appreciate this point, suppose that the corporation has 5 million shares of stock, each of which sells for $50. (Assume for simplicity that stock value is exactly equal to the firm's net value.) The direct effect of the manager's defalcation would be to lower the value of each share of stock by $.02—an amount that seems far too low to trigger market discipline of any sort unless ownership of the corporation is highly concentrated.

262. Bebchuk, *supra* note 210, at 1461-67.

263. From a different perspective, if managerial misbehavior really did not impair the value of a firm to an appreciable extent, it is not clear how much reason shareholders have to be concerned about it.

264. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (1991) (excluding the duty of loyalty from a corporation's right to insulate directors from attack on breach of fiduciary duty grounds).

265. *See* REVISED MODEL BUSINESS CORP. ACT §§ 8.61-.63 (1991). This model act has been adopted in substance in more than 35 states and followed substantially in still others. *Introduction* to *id.* at xvii.

266. *See, e.g.*, Scott v. Multi-Amp Corp., 386 F. Supp. 44, 67 (D.N.J. 1974) (suggesting that interested director transactions will be upheld only if approved by directors and shareholders *and* if the

c. The existence of externalities in state lawmaking.—State lawmaking is suspect, and much more obviously so, in still another respect: Charter competition can be fully effective, and states will enact fully efficient laws, only if state lawmakers take into account all of the costs of the provisions they enact. Because the costs of state lawmaking fall elsewhere in several contexts, the state legislative process appears to be subject to significant externalities.

Externality effects, like market impairment, often are seen as an explanation of state enactment of antitakeover statutes. In this view, the managers of a corporation are a concentrated group that frequently reside in the state of incorporation, whereas shareholders are scattered throughout the country.[267] Thus, in enacting an antitakeover statute, state lawmakers favor local managers at the expense of out-of-state interests.[268]

A second area in which a state law might not fully reflect its costs is corporate disclosure requirements.[269] States may employ disclosure rules that impose higher costs on the issuance of debt and equity securities by large out-of-state companies to protect smaller in-state interests.[270]

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transaction is fair). Delaware's position on this issue is less clear, but also appears to require more than the apparent statutory minimum. *See* Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987) (recognizing that the statutory test is not exclusive and holding that the continued viability of the intrinsic fairness test is "mandated . . . where shareholder deadlock prevents ratification [and] also where shareholder control by interested directors precludes" the independent review called for by statute); Fliegler v. Lawrence, 361 A.2d 218, 221-22 (Del. 1976) (holding that the statutory validation of interested director transactions is not exclusive and applying a two-tiered analysis: application of the statutory test coupled with an intrinsic fairness test).

267. For a brief account of the view that concentrated groups have a competitive advantage over diffuse ones in the legislative process, see *supra* note 169. The description in the text does not fit all states, of course. The managers of a Delaware corporation may not be much more likely to reside within the state than the corporation's shareholders. The differences between Delaware and other states in this and related respects is consistent with Delaware's tardiness in passing an antitakeover provision and with the watered-down nature of the provision that finally was passed. *See* Romano, *supra* note 249, at 855-56 (attributing Delaware's weak antitakeover law to a large and diverse corporate constituency that ensured no single firm's management had the clout to get a stronger law passed).

268. Romano, *supra* note 249, at 855. As noted earlier, corporations located in states with restrictive antitakeover laws will be penalized by the market, but managers appear to have deemed the benefits of protection against takeovers to have been worth the cost. *See supra* note 256.

One concentrated group that often does reside within a given state is potential acquirers. Acquirers have less incentive to oppose antitakeover legislation than managers have to support it, however, because acquirers can always bid for companies in other states—that is, the state in question is only one of fifty possible locations for potential takeover targets. Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE 321, 333 (Margaret M. Blair ed., 1993). Moreover, managers often have nonmonetary reasons to stymie takeover attempts. For them, control of the corporation may be the culmination of a long career. *See id.* at 350 (noting that managers resist takeovers because of their desire for authority, power, and prestige).

269. Recall that I previously discussed a third externality, the federal subsidization of corporate bankruptcy. *See supra* section IV(A)(2).

270. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 367-70 (1991) (noting that farmers and small businessmen supported stringent state securities regulation as a means of undermining out-of-state competition for capital and thereby enhancing their access to credit).

Another externality in state disclosure regulation stems from the likelihood that in the absence of legally mandated disclosure, corporations would inefficiently limit the information they disclose to prevent competitors from having access to this information.[271] Mandated disclosure regulates the level of information that every corporation must provide and thus can eliminate the underdisclosure problem. While states in theory could provide appropriate mandatory rules, their incentive to protect local interests and their ability to export the costs of inefficient laws make state lawmaking suspect. These externalities in state regulation of disclosure are one justification for Congress's significant regulatory role under the securities acts. They also raise questions about the legislating that state lawmakers continue to do.[272]

In each of the areas discussed above—management entrenchment, self-dealing, and externalities—the products of state lawmaking raise doubts as to the desirability of increased state lawmaking.

C. *The Implications of Charter Competition Inefficiency for State Regulation of Corporate Bankruptcy*

As the discussion above has shown, state charter competition breaks down in several areas and thus undermines state regulation of general corporation law in sometimes significant ways. An obvious question is raised by these flaws in state lawmaking: What implications do these shortcomings have for state regulation of corporate bankruptcy?

In this subpart, I begin by briefly considering how each of the inefficiencies discussed above might also be manifested in the bankruptcy context. In the sections that follow, I examine these inefficiencies in more detail and ask, with respect to each, whether federal control would be appropriate. My analysis suggests that the "dark side" of state regulation of corporate bankruptcy is likely to be much less threatening than might at first appear to be the case and that Congress could retain control of those areas where state lawmaking genuinely is suspect. After discussing the areas that could be candidates for congressional regulation, I briefly consider the possibility of eve-of-bankruptcy forum shopping and how this might be prevented.

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271. EASTERBROOK & FISCHEL, *supra* note 205, at 291. Corporations may suffer from a collective action problem in this context: Each might agree to disclose if other firms were required to be equally forthcoming, but none will do so in the absence of a similar commitment by other firms. *See generally* Thomas C. Schelling, *Hockey Helmets, Concealed Weapons, and Daylight Saving: A Study of Binary Choices with Externalities*, 17 J. CONFLICT RESOL. 381 (1973) (discussing prisoners' dilemmas in the context of multiperson decisions involving externalities).

272. *See* Macey & Miller, *supra* note 270, at 395-97 (recounting the effects of local paternalism on state Blue Sky Laws). As discussed earlier, another context where externalities may come into play involves state treatment of nonconsensual creditors. *See supra* note 211.

To appreciate how each of the issues discussed above would play out in the bankruptcy context, consider first the potential for inefficient, management-entrenching legislation by assessing the similarities between bankruptcy and antitakeover protection. Like an antitakeover device, bankruptcy can impair the market's ability to discipline managers because it may substitute reorganization procedures for market mechanisms that would otherwise lead to the ouster of managers outside of bankruptcy.[273] To be sure, bankruptcy is hardly a bonanza for managers because most managers are displaced before the firm finally emerges from bankruptcy.[274] But several aspects of the bankruptcy process may enable a firm's managers to forestall a change in control.[275] Given the states' desire to attract charters and the political influence of the managers in many states, we might expect states to give managers far more control than they currently have in bankruptcy—at the expense of the firm's residual owners. Thus, for example, the market-impairment thesis might predict that states would give a firm's managers the exclusive right to propose a reorganization plan for an unlimited duration.[276]

Just as various aspects of bankruptcy may act in a market-impairing fashion, the second area of concern—self-dealing that fails to trigger market correction—is as relevant in bankruptcy as it is before a petition is filed. In the bankruptcy context, managerial self-dealing most frequently manifests itself in the preferential transfers insiders make to themselves shortly before bankruptcy is filed.[277] Whatever doubts there may be concerning state treatment of self-dealing transactions outside of bankruptcy would be equally applicable to state regulation of preferences.

State lawmaking in bankruptcy would also be subject to externalities comparable to those that affect general corporation law. The transfer of

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273. The "soft landing" Chapter 11 offers managers may have positive benefits, including managerial incentive to resort to Chapter 11 at an appropriate time. ALAN SCHWARTZ & ROBERT E. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES 887 (2d ed. 1991). However, its rules are problematic if their primary effect is to insulate managers from market discipline.

274. Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355, 356 (1990); LoPucki & Whitford, *supra* note 160, at 723-27.

275. Several obvious limitations on changes in control in bankruptcy are Bankruptcy Code § 1107, which contemplates that a debtor's existing managers will continue to run the firm in bankruptcy, 11 U.S.C. § 1107 (1988); Bankruptcy Code § 1121, which gives the debtor-in-possession the exclusive right to propose a reorganization plan for at least 120 days, *id.* § 1121(b); and the uncertainties surrounding voting rights. *See supra* notes 153-60 and accompanying text.

276. Unlimited exclusivity would impose a cost on the states because of its tendency to extend the duration of a bankruptcy case (thus requiring additional judicial and staff time), but the market-impairment thesis might predict that these costs would only temper—without eliminating—states' incentives to give managers control over the reorganization process.

277. Concerns about self-dealing might also be relevant to fraudulent conveyances, although the frequent absence of uncertainty as to whether a fraudulent conveyance is in fact malignant makes a failure by states to regulate them effectively less likely.

bankruptcy authority to the states would eliminate the bankruptcy externality that exists under current law.[278] But other externalities would prove equally problematic in the bankruptcy context. The disproportionate effects of state disclosure rules on out-of-state interests, for instance, raise the same concerns about bankruptcy disclosure that they raise outside of bankruptcy.[279]

1. Federal Lawmaking: Its Virtues and Vices.—Before addressing the specific concerns about state lawmaking, it is useful to consider the nature of federal lawmaking in the corporate law context in more detail than we have done thus far. The most obvious characteristic of federal lawmaking is that a federal provision applies to every corporation, regardless of where the corporation is chartered or where it does business. One virtue of universal application is that Congress is not subject to the externality effects that undermine state lawmaking in some contexts.[280] Federal law's universality also ensures that a mandatory rule—in the event that such a rule is in order—will in fact prove to be mandatory. Because every corporation is subject to a federal provision, firms cannot evade the rule by moving to a state that has adopted a different one.[281]

On the other hand, as discussed earlier, Congress tends to be less responsive to changes in the corporate milieu and slower to refine the corporate laws it enacts—both because of its limitations as an institution and the absence of competitive pressures of the sort that charter competition gives the states.[282] Federal lawmakers also face many of the same interest-group pressures that help to explain states' enactments of inefficient laws in those contexts where charter competition appears to break down. As in the states, managers are sufficiently concentrated that they may outcompete other constituencies—most of which are likely to be more dispersed—in the legislative domain.[283]

The hope that Congress may adopt better laws, at least in a few contexts, rests on two (partially) distinguishing factors. First, in those areas where state lawmaking is suspect, charter competition gives states a particularly strong incentive to succumb to interest-group pressures and to

278. *See supra* section IV(A)(2).

279. While externality effects might also appear to increase the likelihood that states would enact management-entrenching rules, as they did in the antitakeover context outside of bankruptcy, the externality effects arguably are less problematic in bankruptcy, as I discuss in section IV(C)(4).

280. *Cf.* Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 45-46 (1983) (arguing for state authority over antitrust law to promote state competition, except where state regulation has out-of-state taxing effects).

281. *See* Bebchuk, *supra* note 210, at 1496-99 (suggesting that federal law is an appropriate method for ensuring that certain corporate laws are mandated regardless of the state of incorporation).

282. *See supra* text accompanying notes 193-209.

283. Romano, *supra* note 249, at 860.

enact wealth-decreasing laws. In other words, the very forces that make state law appreciably better than federal law in most contexts may make it worse if the competition breaks down.[284]

Second, managers' advantage as lobbyists may be marginally less pronounced at the federal level than at the state level. The notion here is that relatively dispersed groups such as shareholders and affected third parties (including potential acquirers) can wield more influence if they can focus their efforts on a single forum.[285]

Each of these distinctions is at most a difference in degree more than in kind. But in contexts where state lawmaking is particularly suspect, or where the attributes of federal law are desirable, the differences may be sufficiently important to justify a recommendation that Congress retain control.

2. *Manager (and Shareholder) Entrenching Rules.*—States arguably have an incentive to enact value-decreasing corporation laws—in particular, laws that favor managers at the expense of shareholders—if the provision itself tends to neutralize market discipline. Bankruptcy rules that could entrench managers, like antitakeover devices, are suspect on these grounds.

As noted earlier, the exclusive right of managers to propose a reorganization plan is an obvious example of this.[286] As with an antitakeover statute, long-term exclusivity appears to benefit managers at the expense of the firm as a whole. Despite the significant similarities, one distinction between the agency-cost problems reflected in the antitakeover context and those implicated by managers' exclusive right to propose a reorganization plan should be mentioned. While shareholders are the losers if a state enacts an antitakeover statute, the most obvious victims (at least in the short run) in the exclusivity context are creditors. Creditors suffer due to

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284. In discussing the analogous possibility that federal officials might act with insufficient information, Bebchuk remarks: "[W]e may well be better off with officials who would shoot relatively inaccurately at the right target than with officials who would shoot with somewhat greater accuracy but at another, wrong target." Bebchuk, *supra* note 210, at 1502.

285. *See* Romano, *supra* note 193, at 138-39 (discussing the way in which one political group can force legislation through once they concentrate their efforts on that goal). The antitakeover experience can be seen as evidence that Congress is less susceptible to interest-group pressures in certain contexts. In contrast to the states, Congress considered, but never actually enacted, antitakeover legislation of the sort passed by most states. While Romano points out that the same pressures that induced state lawmakers to pass such laws at the expense of corporate shareholders also drove federal lawmakers' deliberations, and that the provisions under discussion often were particularly stringent, the fact remains that none of the provisions ever became law. *See* Romano, *supra* note 249, at 860-61. The only actions Congress did in fact take were minor and peripheral, such as its amendment of § 163 of the Internal Revenue Code. *See* 26 U.S.C. § 163 (1988) (providing for the disallowance of the interest deduction for particularly risky debt). This suggests that the prospects for opportunistic lawmaking may be muted at the federal level, at least in some contexts.

286. *See supra* notes 275-76 and accompanying text.

the value-decreasing effect of long-term exclusivity. Shareholders, on the other hand, may benefit, both because existing managers continue to identify with shareholders' interests in some cases[287] and because shareholders can use the threat of a lengthy case to extract concessions from other constituencies.[288]

Do these kinds of agency costs necessitate federal intervention? The most obvious argument for federal regulation in this context is one we have already seen: Because charter competition prods states to maximize shareholder value, states have a systematic incentive to provide bankruptcy rules that (like long-term exclusivity) divert value from creditors to shareholders. The problem with this reasoning is that creditors will charge more for credit if the state's bankruptcy rules impair their interests. Because both shareholders and managers will be worse off if states enact bankruptcy laws that inefficiently divert wealth from creditors to shareholders in bankruptcy, states have a disincentive to do so.[289]

Of course, market discipline may break down. Just as managers persuaded states to enact antitakeover statutes in response to the takeover boom, managers might persuade state lawmakers to enact value-decreasing bankruptcy rules if an end-game dynamic of comparable proportions arose in the bankruptcy context. If an extraordinary crisis forced an unusual number of corporations (or even a single prominent corporation) into bankruptcy, state lawmakers might opportunistically amend their bankruptcy regime to help local corporations.[290]

On the other hand, the externality effects that may have contributed to the willingness of state lawmakers to enact antitakeover legislation may be appreciably less pronounced in the bankruptcy context. In contrast to

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287. Existing managers do not always favor shareholders. On the contrary, LoPucki and Whitford conclude in their empirical study of Chapter 11 that existing managers varied in the extent to which they favored shareholders (as opposed to creditors, or maximization of the estate generally). LoPucki & Whitford, *supra* note 160, at 742-47.

288. *See* Skeel, *supra* note 126, at 485-86 (noting that shareholders have an incentive to prolong the proceeding because they would be least likely to receive anything upon immediate liquidation); *see also* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 158-59 (1989) (arguing that equity interests and general creditors prefer that the business be continued due to their poor prospects in the event of a liquidation).

289. *See supra* notes 210-11 and accompanying text. Simply put, the capital (and product) markets will constrain state lawmaking in this context, much as they do in general corporation law.

290. Several states' enactment of stay laws in response to the economic crises of the nineteenth century arguably can be seen as an example of state lawmakers' protection of in-state residents. WARREN, *supra* note 21, at 51, 87-90, 146-53. Yet it is important to keep in mind that the stay laws were designed primarily to protect individual debtors, rather than corporations, and that it was not entirely clear whether the laws were in fact value-decreasing as a whole. *See id.* at 146-53 (suggesting that the laws, many of which were eventually struck down by the Supreme Court, slowed the effects of economic crisis).

the shareholders that have been victimized by antitakeover law, the creditors who would bear much of the cost of management-entrenching bankruptcy rules seem more likely to reside within the forum state.[291] In consequence, managers might have more difficulty persuading a state to adopt management-entrenching bankruptcy provisions. But the specter of opportunistic amendment by the states is a real one and suggests, at the least, that federal control merits consideration.

The inflexibility of federal rules would be both an advantage and a disadvantage of Congress's retaining control of provisions susceptible to opportunistic amendment. Federal control is attractive because Congress is less likely to alter the provisions under pressure from managers and shareholders in the face of a perceived crisis. On the other hand, congressional inertia also means that an inappropriate federal rule is more likely to endure than ill-advised state legislation.[292]

Ideally, Congress might resolve this tension by permitting the states to regulate issues such as exclusivity, but imposing a federal safeguard such as a requirement that shareholders opt in to any change in the background rule.[293] Unfortunately, while a shareholder opt-in requirement might solve the opportunistic amendment problem for most corporate issues, such an approach offers less promise in the bankruptcy context because shareholders' incentives are perverse in insolvency. Because value-decreasing

291. Further, creditors such as banks tend to be less dispersed than shareholders and have been particularly effective as lobbyists at both the national and the state level. *See* Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411, 417 (1990) (arguing that creditors got what they wanted under the current Bankruptcy Code).

To the historically minded, these observations might at first seem counterintuitive. In the nineteenth century, state lawmaking often appeared to reflect local concerns. *See, e.g.*, WARREN, *supra* note 21, at 32-33 (discussing Virginia's extremely loose bankruptcy laws, which were designed to protect Virginia's freehold system). Northeastern states, which were already the nation's primary money center, tended to have a pro-creditor bias, whereas the laws of the Southern states protected land-holding debtors (for example, with generous exemption laws). *Id.* at 33-37. One might argue that these kinds of regional differences, which were consistently reflected in the states' positions on national bankruptcy legislation, would continue to shape state lawmaking if the states were given control over corporate bankruptcy. *See* WARREN, *supra* note 21, at 30-33 (noting that Southern lawmakers opposed national bankruptcy legislation, fearing it would jeopardize farmers' homestead exemptions). For example, agricultural or industrial states might favor debtors at the expense of out-of-state, money-center creditors. The development of robust interstate markets, however, has diminished the likelihood of significant parochialism, and even states without significant money centers are likely to have a potent creditor lobby.

292. Black, *supra* note 206, at 581.

293. Black has made this argument in more general terms, suggesting that federal lawmaking should be limited to "change-governing" rules, such as a requirement that any charter amendment or other major corporate action be approved by a majority of the firm's shareholders. *Id.* at 581-83. An opt-in requirement is not a foolproof solution to opportunism, however, even under the best of circumstances because of the collective action problems that often prevent shareholders from wielding their vote effectively. Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 43-44 (1988).

bankruptcy rules may benefit them *ex post*, shareholders may favor an opportunistic amendment that is undesirable for the firm as a whole.[294] An alternative approach would be to condition amendment on creditor approval, but creditor voting is also problematic outside of bankruptcy.[295] Nonetheless, a creditor opt-in requirement is more promising than a provision that gives decisionmaking authority to shareholders.[296]

In sum, the most obvious means of eliminating the possibility of opportunistic amendment would be either to impose substantive federal standards in this context or to require creditor approval of any change in a bankruptcy rule that, like the exclusivity period, could increase entrenchment. Given the uncertainty whether states would in fact succumb to manager and shareholder pressures on exclusivity and related issues, however, and given the shortcomings of federal lawmaking, it is questionable whether federal regulation would be desirable, at least until problems actually do arise.

3. *Failure to Trigger Market Correction: Preferences*.—The second concern with state regulation of bankruptcy is that managers might opportunistically demand legislation that allows self-dealing in areas that do not trigger market correction. The most obvious context where such manager opportunism might occur involves preferential transfers. Because managers benefit from lenient preference rules and because the market effect of a preferential transfer may at times be relatively small,[297] managers could seek and states provide increasingly lax preference laws.

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294. Shareholders' incentives will depend in large part upon the financial health of the corporation. If the corporation is fully solvent, shareholders are less likely to prefer a bankruptcy regime that would divert wealth to them from creditors because a firm subject to inefficient rules of this sort would be penalized by the market. *See* Lin, *supra* note 99, at 1503 ("If a company has the reputation of engaging in opportunistic behavior at its creditors' expense, new investors either will refuse to do business . . . or will adjust the terms of their loans to reflect the perceived increase in default risk."). Market constraints will be decreasingly effective, however, as the financial health of the firm deteriorates. *See id.* at 1489-91 (noting that stockholders have little to lose when a firm enters financial distress and, consequently, will be willing to undertake riskier projects).

295. Unless the corporation is deeply insolvent, creditors will be inefficiently risk averse in their decisionmaking. *See* Lin, *supra* note 99, at 1489-93. Further, outside of bankruptcy, creditors would suffer from the same kinds of collective action problems that impair shareholder voting. *See* Gordon, *supra* note 293, at 39-55 (discussing the collective-action problems associated with shareholder voting, including voter apathy and lack of sufficient incentive to organize opposition to particular proposals).

296. The collective-action problem, for instance, could be at least partially addressed by the appointment of a committee to represent creditors' interests.

297. This assertion will hold true in the publicly held corporation context. In closely held corporations, managers' preferences seem more likely to involve a significant portion of the firm's assets. In this context, any market failure that occurs has less to do with the size of the transfer than with other factors, such as managers' perverse end-game incentives and the possibility that collective action and information problems will prevent creditors from challenging preferential transfers. *See supra* note 88 and accompanying text. Notice that the problem here is more an enforcement problem than a problem with the preference law itself (and that it exists under current federal law).

The problem with this analysis is that it is not at all clear that state lawmaking truly is suspect in the preference context. As discussed earlier, if a preference law did in fact excessively favor managers, the law almost certainly would have sufficient indirect costs to trigger market correction.[298] Moreover, none of the other concerns about state lawmaking appear to apply to preference regulation. The end-game dynamic that pressured states to enact antitakeover statutes is unlikely to have the same effect in the preference context, even in the face of a crisis. Nor could states export the costs of a value-decreasing approach to preferences because (as with the manager-entrenching rules discussed in the preceding section) the creditors who are likely to be most affected will often reside in the state.[299]

In short, the case for federal control is even more debatable in the preference context than it is with respect to management-entrenching devices such as long-term exclusivity.

4. Disclosure and Other Information-Forcing Rules.—Because the disclosure rules in bankruptcy may have disproportionate effects on out-of-state interests, states arguably might ignore these externalities and thus enact inefficient regulations. Indeed, it was the perception that state regulation of general corporate disclosure law was ineffective that led Congress to federalize much of this area with the Securities Acts of 1933 and 1934.[300] I have already considered how the potential spillover effect of state disclosure regulation helps to justify the use of mandatory federal rules.[301] To appreciate the applicability in the bankruptcy context of this and each of the other standard justifications for federalization of disclosure, I begin by looking at the effects of mandatory disclosure in more detail.

Consider first the effect of mandatory disclosure of financial information on investment analysts' search efforts. In the absence of disclosure,

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298. *See supra* text accompanying note 263.

299. To the extent a case for federal regulation of preferences can be made, it probably rests not on a perceived failure to trigger market correction, but on a contention that preference problems are most severe in the context of closely held corporations, *see supra* note 297, and that states tend to neglect closely held corporation issues. Black, *supra* note 206, at 582 (commenting that the best, though uncertain, case for substantive federal rules is in closely held corporations). The suggestion that states focus only on publicly held corporations is debatable, however, as evidenced by Delaware's early adoption of a special set of provisions designed specifically for closely held corporations. Act of July 3, 1967, ch. 50, 56 Del. Laws 242 (1967) (codified as amended at DEL. CODE ANN. tit. 8, §§ 341-356 (1991)). Moreover, even if a state did consider only publicly held corporations, preferences are a significant enough issue in that context that they almost certainly would attract the attention of lawmakers.

300. *See* Securities Act of 1933, ch. 38, tit. I, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77 a-bbbb (1988)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78 a-kk (1988)).

301. *See supra* notes 269-72 and accompanying text.

much of the investigation done by a securities analyst would be duplicative, because other analysts must cover precisely the same ground in their effort to assess the prospects of a particular corporation.[302] To be sure, the corporation itself might help to alleviate this problem through voluntary disclosure because firms have an incentive to provide information—and thus, to obviate the need for duplicative searches—in order to keep the market apprised of their status.[303] Yet, if firms were left to their own devices, many would underdisclose or distort disclosure in various contexts. In the face of a hostile takeover, for instance, managers might attempt to exaggerate the value of a corporation; if managers wished to effectuate a management buyout, on the other hand, they would distort their disclosure in the opposite direction.[304] The existence of perverse incentives of this sort suggests that mandatory disclosure rules are necessary to ensure both that a corporation provides an adequate amount of disclosure and that the information provided is accurate.

These same perverse incentives are present when a bankrupt corporation is reorganizing under Chapter 11.[305] Managers have a tremendous incentive to distort information as they attempt to achieve consensus on a reorganization plan because they must convince each creditor class that the liquidation value of the corporation's assets is less than the value as a going concern.[306] Because it is unlikely that an effective market for corporate control will exist to keep management in check, the case for mandatory disclosure rules is, if anything, even stronger in the bankruptcy context.[307]

The analysis thus far helps to explain mandatory disclosure but does not explain the need for federal involvement. In theory, the states them-

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302. *See* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 723-33 (1984) (arguing that without the Securities Exchange Act of 1934 there would be less market research because the cost of research would be higher).

303. EASTERBROOK & FISCHEL, *supra* note 205, at 288.

304. Coffee, *supra* note 302, at 740-43.

305. Notice that a reorganization plan proposed by the firm's managers is similar to a management buyout—a context where managers' disclosure incentives obviously are suspect. *Id.* The primary differences between reorganization and a management buyout are that managers' ownership interest tends to be far smaller after a confirmation of a reorganization plan and that managers frequently do not contribute new value to a bankruptcy reorganization.

306. *See* 11 U.S.C. § 1129 (1988) (mandating that each creditor class approve the reorganization plan).

307. Under current bankruptcy law, a corporation that files for Chapter 11 relief is subject to a series of bankruptcy-imposed disclosure requirements. *See, e.g.*, *id.* § 521 (requiring a debtor to file a schedule of assets and liabilities); *id.* § 704(8) (requiring periodic disclosure in Chapter 7 cases); *id.* § 1125 (requiring a plan proponent to file a disclosure statement in connection with a reorganization plan). A corporation may also be required to continue making disclosure under the federal securities laws, unless the SEC agrees to permit the corporation's bankruptcy filings to satisfy its securities law responsibilities. *See, e.g.*, Angeles Corp., SEC No-Action Letter, 1993 WL 282758 (S.E.C.), FSEC-NAL Database (July 23, 1993); Zale Corp., SEC No-Action Letter, 1992 WL 227960 (S.E.C.), FSEC-NAL Database (Sept. 11, 1992) (both allowing the substitution of bankruptcy reports for filings required under the Securities Act of 1934).

selves could establish appropriate disclosure requirements. But the same externality concerns that make state regulation of disclosure suspect outside of bankruptcy are equally applicable in the bankruptcy context.[308] As discussed above, states might use their disclosure requirements to impose costs on out-of-state firms and fail to account for the benefits to investors in similarly situated (and therefore competing) corporations.[309] The universality of federal disclosure requirements eliminates each of these problems.

The case for federal regulation of disclosure in bankruptcy may also apply in other contexts involving the production of information, such as the process of filing a claim in bankruptcy. The current regime provides both a standard format for claimants to use in filing their claim and a framework for determining the validity and amount of the claim.[310] Because states could use the claims process to impose costs on out-of-state claimants, federal regulation may also be in order in this context.[311]

In addition to ensuring adequate provision of information and eliminating the externalities that undermine state lawmaking, standardizing disclosure and the format for filing a claim also could minimize analysts' and claimants' investigation costs. From this perspective, standardized requirements can be seen as a collective good that reduces the costs of participating in bankruptcy cases in different states.[312]

5. *Forum Shopping*.—As the discussion thus far indicates, the need for federal involvement in a state bankruptcy regime appears to be quite limited. Congress clearly should regulate bankruptcy's disclosure requirements. The case for federal control is more questionable in other areas, such as exclusivity and other management-entrenching rules, and is even more problematic with respect to preferential transfers.

In addition to these concerns with state lawmaking, we must also consider a final concern: the possibility that, even if state regulation were otherwise unproblematic, corporations might evade state lawmaking

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308. *Cf.* EASTERBROOK & FISCHEL, *supra* note 205, at 300, 300-02 ("Competition among the states cannot produce all benefits [of disclosure] because of the interstate nature of some of these effects; if being a holdout is in the interest of some firms, it should pay states to be havens to the holdouts.").

309. *See supra* notes 269-72 and accompanying text.

310. *See* 11 U.S.C. app. form 19 (1988) (setting forth the standard proof of claim); *id.* § 502 (requiring the court to determine the validity and amount of a claim after notice and a hearing if the claim is objected to and allowing the claim in the absence of an objection).

311. The argument here is an argument for possible federal regulation of the *framework* for filing and determining the amount of a claim, not for the substantive standards to be used by a state court in making the actual assessment.

312. *Cf.* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 286-88 (1985) (discussing the benefits of state-sponsored standardization in terms of contract formulation).

through forum shopping.[313] In the face of financial distress, the managers of some firms might reincorporate in another state to take advantage of the state's more manager-friendly bankruptcy laws, just as a few corporations did in the antitakeover context.[314] But managers cannot simply reincorporate at will. Not only is reincorporation costly, but the managers ordinarily must obtain shareholder approval of any proposal to move the firm. Yet, as discussed earlier, shareholder approval may not prove to be an effective check, especially given that the new state's manager-friendly bankruptcy regime may also be more shareholder-friendly.[315]

Perhaps the most effective way to curb forum shopping would be for Congress to neutralize the effects of reincorporations made immediately before bankruptcy. As part of a choice-of-law provision requiring state courts to apply the bankruptcy laws of a firm's state of incorporation,[316] for instance, Congress might mandate the application of the bankruptcy laws of a firm's former state of incorporation, rather than those of its new one, if the firm switches states within the two years prior to bankruptcy. To be sure, an anti-forum-shopping provision of this sort raises several concerns. First, the provision inevitably would have an overinclusive effect, invalidating at least a few appropriate jurisdictional changes in addition to those it was designed to counteract. Second, and somewhat similarly, because charter competition is the mechanism that prods state lawmakers to adopt more efficient laws, any law that chills competition should be viewed with suspicion. Because a firm's unfettered ability to reincorporate if it so chooses is a key component of charter competition, a forum-shopping prohibition would, at least in a limited way, have such an effect. Yet, despite these question marks, managers' incentives seem sufficiently

313. The forum shopping I have in mind here is forum shopping with respect to choice of law. A similar concern is the possibility that corporations will engage in venue shopping. For instance, a Delaware corporation that conducts significant business in Illinois might file its bankruptcy petition in Illinois in the hope of particularly sympathetic treatment by an Illinois bankruptcy judge. While venue shopping may be a concern in some cases, it is important to keep in mind that analogous venue shopping already occurs under the current federal system. *See* Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11, 13 (noting that bankruptcy petitioners consciously choose the district where the case proceeds and that they sometimes choose a district where the firm has virtually no physical presence). Moreover, venue shopping could even decrease if states regulated corporate bankruptcy, since the applicability of the bankruptcy law of the state of incorporation might make it more difficult to justify a corporation's filing in a state with which it has only a tenuous connection than currently is true in Chapter 11, where the same federal bankruptcy regime applies regardless of where the case is filed.

314. *See supra* note 257 and accompanying text.

315. *See supra* notes 293-95 and accompanying text.

316. *See supra* text accompanying note 223.

perverse on the eve of bankruptcy, given the end-game characteristics of their decisionmaking at that point, to warrant a limited antiforum-shopping rule. Thus, in addition to requiring disclosure, the analysis suggests that Congress should include an anti-forum-shopping component to any choice-of-law provision it enacts in order to minimize corporations' ability opportunistically to change jurisdictions on the eve of bankruptcy.

V. Legal Impediments to State Regulation of Corporate Bankruptcy

The discussion in the previous Part took place almost entirely at a normative level. I argued that many of the problems created by a system that artificially separates general corporation law and corporate bankruptcy could be eliminated, and both corporate law and bankruptcy law improved, if authority over corporate bankruptcy were, with a few exceptions, shifted from Congress to the states.

To this point, I have assumed that such a proposal could be implemented under current law in the event it proved persuasive. In this Part, I relax that assumption and focus explicitly on the question whether the states could in fact regulate corporate bankruptcy if Congress gave them authority to do so. I briefly consider several possible constitutional obstacles in the subparts that follow.[317]

A. Constitutional Limitations on State Impairment of Contracts

Perhaps the most obvious obstacle to state regulation of corporate bankruptcy is a constitutional one. Article I, Section 10 expressly prohibits any state from enacting "a Law impairing the Obligation of Contracts."[318] The current federal bankruptcy laws, like any bankruptcy system, impair contracts in various respects, perhaps most obviously by imposing an automatic stay on creditors' efforts to collect their debt[319] and by discharging a debtor corporation on payment of less than the full amount owed.[320] Because federal lawmakers are not subject to its strictures, the Contracts Clause does not itself prohibit Congress from enacting

317. In addition to the constitutional questions I discuss below, the other obvious practical impediment to shifting authority to the states is the question of whether such a proposal could ever be passed. I briefly consider this last—and in some respects most important—barrier in the conclusion that follows this Part.

318. U.S. CONST. art. I, § 10.

319. 11 U.S.C. § 362 (1988). In the nineteenth century, efforts by the states to impose stays on existing debts were often (although not always) struck down in the courts. WARREN, *supra* note 21, at 150-51. The Supreme Court invalidated the use of stays on impairment of contracts grounds in 1877. Edwards v. Kearzey, 96 U.S. 595, 601-02 (1877).

320. Under Bankruptcy Code § 1141(a), a reorganization plan is binding on all creditors and other interested parties, and under Bankruptcy Code § 1141(d), confirmation of a plan discharges all of a debtor's debts. *See* 11 U.S.C. §§ 1141(a), (d) (1988).

provisions of this sort.[321] By contrast, the Contracts Clause appears on its face to preclude any significant state regulation of corporate bankruptcy.

The Supreme Court has never construed the Contracts Clause to be nearly so broad as the language seems to suggest, however. In addressing state bankruptcy authority in the early case of *Sturges v. Crowninshield*,[322] the Supreme Court held that while a state could not enforce its bankruptcy laws in such a way as to give them retrospective effect, the Contracts Clause does not prohibit a prospective state bankruptcy law.[323] Even a prohibition against prospectively impairing contracts might appear to significantly undermine the states' ability to regulate corporate bankruptcy, at least if it precludes states from applying any provision that is amended after the contract in question was executed. Yet a state can easily avoid this problem. Just as states have long used "reservation of power" clauses to prevent shareholders from challenging the applicability of subsequent changes in corporate governance law on impairment of contracts grounds,[324] states could enact similar provisions (or expand their existing provisions) to protect subsequent changes to their bankruptcy provisions from Contracts Clause attacks by creditors whose contracts predated the changes.

Thus, the only class of claimants who could object to a state bankruptcy act on these grounds are creditors whose contracts predate passage of the original act.[325] Existing shareholders could not protest the legislation since their rights are already subject to modification under the reservation-of-power provisions described above. Future creditors also

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321. This is not to say that Congress has unlimited authority to impair contracts. Other constitutional requirements, such as the Fifth Amendment's due process requirement and prohibition of takings, reign in Congress to some extent. *See* U.S. CONST. amend. V; Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 601-02 (1935) (holding the Frazier-Lemke Act unconstitutional on due process grounds because it scaled down the indebtedness of a mortgagor of farm property to present value).

322. 17 U.S. (4 Wheat.) 122 (1819).

323. *Id.* at 207; *see also* Ogden v. Saunders, 25 U.S. (12 Wheat.) 213, 368-69 (1827) (holding that bankruptcy laws can be applied only prospectively).

324. *See, e.g.*, DEL. CODE ANN. tit. 8, § 394 (1991). The Delaware provision states that "any amendment or repeal shall not take away or impair any remedy under this chapter against any corporation or its officers for any liability which shall have been previously incurred." *Id.* The widespread use of these clauses can be traced, at least in part, to their having received Justice Story's imprimatur in his concurring opinion in Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 693-95 (1819).

325. Even with respect to existing creditors, the prohibition against impairing contracts has not been viewed as absolute. The Supreme Court has suggested that the purpose of the Clause is to protect parties' reasonable expectations, not to prevent every retrospective law. *See, e.g.*, Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934) (upholding a Minnesota law granting debtors relief from mortgage foreclosures during the economic crisis of the Depression); Ronald D. Rotunda, *The Impairments of Contracts Clause and the Corporation: A Comment on Professors Butler's and Ribstein's Thesis*, 55 BROOK. L. REV. 809, 824-29 (1989) (concluding that the Supreme Court has interpreted the Contracts Clause as protecting the reasonable expectations of the parties).

could not protest, so long as the bankruptcy provisions were in place at the time of the contract.

In short, the limitations imposed by the Contracts Clause on state lawmaking would, at most, constitute a transition problem for the proposal to shift bankruptcy authority to the states. As soon as a corporation had completed any contracts that predated enactment of a state bankruptcy act, the corporation would be fully subject to the provisions of the act. In the interim, a state could simply continue to apply Chapter 11 to corporations with contracts predating passage of the state's bankruptcy law. Alternatively, states could take the position that, so long as the state legislation provided at least as much protection for creditors as the existing Bankruptcy Code, state legislation should not be seen as impairing an existing creditor's contract.[326] In this view, a creditor whose contract already might be subject to impairment under federal bankruptcy law could not legitimately complain simply because the source of the provisions had changed.

B. *The Limitations on the Ability of the States to Assert Personal Jurisdiction over the Parties*

Inability to assert jurisdiction over out-of-state parties would have undermined a state corporate bankruptcy statute in the nineteenth century and may have played a role in Congress's eventual decision to include corporations in the Bankruptcy Act of 1867.[327] Because the Supreme Court has dramatically expanded states' jurisdictional reach in recent decades, personal jurisdiction requirements do not have so great a constraining effect as once was the case. Yet, even under the current view of personal jurisdiction, it is not difficult to imagine how, at least in some circumstances, personal jurisdiction over some potential claimants might appear to be in doubt.

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326. Such an argument would seem to accord with the Supreme Court's jurisprudence in this area and its suggestion that the Contracts Clause is primarily concerned with protecting parties' reasonable expectations. *See supra* note 325.

327. *See Ogden*, 25 U.S. (12 Wheat.) at 368 (holding that "discharge under a state law [is] incompetent to discharge a debt due a citizen of another state"). States resolved personal jurisdiction and related problems under the equity receiverships that developed in the late nineteenth and early twentieth centuries by treating the receivership as an in rem proceeding, *see* 8 SEC REPORT, *supra* note 62, at 30, much as they do today with state receivership and assignment-for-the-benefit-of-creditors regimes. This option also would be available in the bankruptcy context, although it has two practical drawbacks. First, for those corporations with property in multiple jurisdictions, ancillary proceedings would have to be set up in each of the states. *Id.*; Frank H. Buckley, The American Stay 68, 72 (Feb. 25, 1993) (unpublished manuscript on file with the *Texas Law Review*). Second, this approach would require in many cases that the proceeding be conducted in the state where a corporation's principal place of business is located, rather than the state of its incorporation, thus sacrificing some of the virtues of charter competition. Although neither obstacle is prohibitive, a state regime that is not tied to the physical location of a firm's assets obviously would be simpler and more effective.

Consider, for instance, a Delaware corporation with its principal place of business in Illinois that entered into a contract in California with a California supplier. If the corporation filed its bankruptcy petition in Delaware, and the California supplier had no contacts with Delaware other than having contracted with a Delaware corporation, the minimum contacts requirement would appear not to have been met.[328]

Viewed from another angle, however, it is less obvious whether difficulties of this sort would in fact limit the reach of a state court bankruptcy case. The reasoning goes as follows: The ability to assess and to provide for the potential scaling down of claims is a necessary component of any bankruptcy system. No claimant is required to participate in the claims process, but any claimant who wishes to receive a distribution must file a proof of claim.[329] Because a claimant who files a proof of claim has effectively submitted to the jurisdiction of the bankruptcy court, personal jurisdiction issues like those posed by the California supplier would in practice take care of themselves. Claimants would have a choice whether to submit to the state court's jurisdiction or to forfeit their right to participate; either way, their interest, like that of every other party, would be resolved by the bankruptcy proceeding.

The principal question evoked by this reasoning is whether it adequately respects a creditor's due process right not to be haled into a forum with which it has few or no contacts.[330] The claims process in a bankruptcy case has the effect of deciding any cause of action on which a claim is based.[331] Yet, in the absence of bankruptcy, the Delaware court could

328. Even under the broadest reading of the Supreme Court's personal jurisdiction cases, a party cannot be called into court in a state unless the party has purposefully availed itself of the benefits of the forum in some way. *See* Hanson v. Denckla, 357 U.S. 235, 253 (1958) ("[I]t is essential in each case that there be some act by which the defendant purposefully avails itself of the privilege of conducting activities within the forum State."). In one of its more recent personal jurisdiction decisions, the Court suggested that the reasonableness of a particular forum can be taken into account in connection with the minimum contacts analysis. Burger King Corp. v. Rudzewicz, 471 U.S. 462, 476-77 (1985). Given the need to bring all interested parties within the bankruptcy forum, this approach would seem to argue for a particularly expansive view of personal jurisdiction. But the Court also stated that "[i]f the question is whether an individual's contract with an out-of-state party *alone* can automatically establish sufficient minimum contracts in the other party's home forum, we believe the answer clearly is that it cannot." *Id.* at 478 (emphasis in original).

329. The current Bankruptcy Rules have such a requirement. *See* FED. R. BANKR. P. 3021. The analysis assumes, of course, that the claimant has been given proper notice of the bankruptcy case and of the need to file a claim. *See* Brown v. General Motors Acceptance Corp. (*In re* Brown), 27 B.R. 151, 153 (Bankr. N.D. Ohio 1982) (holding that creditors must be given notice of the bankruptcy case in time to file a proof of claim).

330. The question of personal jurisdiction is less significant in the event the corporation is liquidated rather than reorganized because, as a practical matter, a claimant who declines to file a claim has no assets to pursue once the bankrupt's assets have been sold and the proceeds distributed.

331. *See* 11 U.S.C. § 502(c)(1) (1988) (authorizing the bankruptcy court to estimate "any contingent or unliquidated claim, the fixing or liquidation of which . . . would unduly delay the administration of the case").

not have asserted personal jurisdiction over the California supplier and, thus, could not have decided the case.[332] The concern, then, is that giving claimants a choice to submit to jurisdiction or waive their claim has the effect of undermining the ordinary limitations on a court's ability to assert personal jurisdiction.

Is there any other way a forum state could assert bankruptcy jurisdiction over a claimant that has little contact with the forum state? The easiest solution—were it effective—would be for the state to enact a jurisdictional provision providing that a firm that entered into a contract with one of its corporations would be deemed to have consented to jurisdiction in the state of incorporation for bankruptcy purposes. Delaware has enacted an analogous provision providing that acceptance of a directorial position with a Delaware corporation constitutes consent to jurisdiction in Delaware if the director is sued.[333] Because the relationship between a contract creditor and the corporation is much more attenuated than that of a director, however, a statutory consent to bankruptcy jurisdiction seems less likely to be upheld as a constitutional measure.

Another possible approach would be to argue that because state courts would in effect be exercising Congress's Bankruptcy Clause powers if Congress were to shift authority over corporate bankruptcy to the states, they should be deemed to have (or Congress could enact legislation giving them) the same jurisdictional reach as the federal bankruptcy courts currently have. Just as current Bankruptcy Rule 7004 enables bankruptcy courts to effect service of process anywhere in the country,[334] a similar provision might ensure that a state court could assert jurisdiction over every necessary party.[335] The primary question with respect to this analysis is

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332. Notice that the jurisdictional problem presents an interesting twist in the bankruptcy context. The ordinary personal jurisdiction case raises the question whether a court can assert jurisdiction over an out-of-state defendant. *See, e.g.*, Burnham v. Superior Court, 495 U.S. 604 (1990). In the bankruptcy context, on the other hand, the party in question is in a sense a *plaintiff*, given that the jurisdictional question is whether a claimant can be compelled to pursue her case in the bankruptcy context. *See, e.g.*, In re *Brown*, 27 B.R. at 151. Jurisdictional questions may also arise where the corporate debtor seeks to sue an out-of-state party in state court, but the corporation can simply pursue its cause of action in the foreign state if the state where the bankruptcy case was filed lacks jurisdiction. *See* Milliken v. Meyer, 311 U.S. 457, 463 (1940) (finding that domicile coupled with personal service is adequate to establish personal jurisdiction).

333. DEL. CODE ANN. tit. 10, § 3114(a) (Supp. 1992). Delaware previously had attempted to ensure jurisdiction over any internal issue relating to a corporation incorporated within the state by enacting a law which stated that Delaware was the locus of every share of stock in any Delaware corporation in an effort to establish quasi in rem jurisdiction based on the location of the stock. *Id.* § 366 (1991). The Supreme Court held, however, that Delaware cannot exercise quasi in rem jurisdiction if the defendant lacks minimum contacts with the state. *See* Shaffer v. Heitner, 433 U.S. 186, 208-09 (1977).

334. *See* FED. R. BANKR. P. 7004(d).

335. For examples of cases upholding bankruptcy courts' use of Bankruptcy Rule 7004, even with respect to state-based causes of action, see Diamond Mortgage Corp. v. Sugar, 913 F.2d 1233, 1243-44

whether it would be seen as an impermissible attempt by Congress to delegate federal power.[336]

In sum, Supreme Court jurisprudence on personal jurisdiction has changed dramatically since the nineteenth-century bankruptcy debates. Yet uncertainties remain concerning both the Court's likely treatment of personal jurisdiction in the bankruptcy context and the efficacy of various possible solutions. The alternative is to treat bankruptcy as, in effect, an in rem proceeding and to set up ancillary proceedings in additional states if necessary. The states currently employ a similar approach in regulating insurance insolvencies, which suggests that none of the jurisdictional obstacles discussed above is insurmountable.[337]

C. *The Limitations on the Ability of the States to Control Out-of-State Matters*

Other concerns with the plausibility of state regulation of corporate bankruptcy stem from limitations on a state court's authority over out-of-state property and over litigation commenced in a foreign jurisdiction. As the following discussion demonstrates, neither of these obstacles is insurmountable.

Because the state where real estate is located has exclusive subject matter jurisdiction over it, state courts cannot issue orders that operate directly on land in another state.[338] Given that many corporations own real estate in more than one state, this limitation on a state court's jurisdiction could significantly undermine the effectiveness of a state law corporate bankruptcy regime.[339]

(7th Cir. 1990) (holding that courts may apply Bankruptcy Rule 7004 in allowing nationwide service of process in "non-core, related proceedings"), *cert. denied*, 498 U.S. 1089 (1991); Teitelbaum v. Choquette & Co. (*In re* Outlet Dep't Stores, Inc.), 82 B.R. 694, 696-97 (Bankr. S.D.N.Y. 1988) (holding that the Supreme Court had the authority through Congress to promulgate Bankruptcy Rule 7004).

336. The jurisdiction issue also could be addressed by the corporation itself; in particular, a corporation could include jurisdictional consent provisions in its contracts. Provisions of this sort have been routinely included in contracts. *See* FLEMING JAMES, JR. ET AL., CIVIL PROCEDURE § 2.9, at 71 (4th ed. 1992) (noting that such forum stipulation clauses "are an increasingly common feature in contracts involving interstate and foreign commerce"). To be sure, the inclusion of a bankruptcy jurisdiction provision would not be a complete solution to the personal jurisdiction issue because the provision only applies to consensual creditor relationships governed by a written contract. But use of such provisions could reduce the likelihood that a state court's jurisdictional reach would be insufficient in a given bankruptcy case.

337. For a discussion of the drawbacks of states' use of a similar approach in the receivership context, see *supra* note 327. These limitations reinforce the notion that the in rem approach is a second-best solution to potential jurisdiction problems.

338. Fitch v. Huntington, 102 N.W. 1066 (Wis. 1905); EUGENE F. SCOLES & PETER HAY, CONFLICT OF LAWS § 24.10 (2d ed. 1992).

339. The difficulty of adjudicating interests in out-of-state property was another potential problem

In practice, however, a state's lack of subject matter jurisdiction over property in another state is less problematic than initially appears to be the case. While a state court judgment could not operate directly on out-of-state land, the Supreme Court has suggested that so long as the court has personal jurisdiction over the parties, it can effectively adjudicate the rights of the respective parties.[340] Thus, a decision arbitrating the respective interests of a debtor and a secured creditor in out-of-state real estate might resolve the parties' respective entitlements, even if the judgment could not by itself be enforced against the land.

To actually enforce the judgment, a party must obtain an appropriate decree in the jurisdiction where the land is located. So long as the judgment was validly obtained, this too should not be a problem because the Full Faith and Credit Clause of the Constitution requires a state to recognize the judgments issued by a sister state.[341] Moreover, by invoking its authority to implement the Full Faith and Credit Clause, Congress could itself establish a simple registration process, much as it has done to facilitate the registration of federal court judgments in different districts.[342]

A second concern with the ability of the states to influence matters beyond their borders relates to litigation pending in other fora. In recognition of the sovereignty of other states and the potential for unseemly interstate squabbles if each state attempted to protect its jurisdiction in connection with related cases initiated in different states, states are reluctant to interfere with out-of-state proceedings.[343] States have even less control

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that state equity receiverships solved by establishing ancillary proceedings in all of the states where a corporation's property was located. *See supra* note 327. As with personal jurisdiction, limitations on a state court's authority over foreign property could be addressed in an analogous fashion. The Uniform Insurers Liquidation Act employs precisely this approach in the insurance context in those states that have adopted it. UNIF. INSURERS LIQUIDATION ACT § 3, 13 U.L.A. 321, 341 (1986) (providing for the appointment of an ancillary receiver for insurers domiciled in another state). The alternative approach suggested in this subpart is a less cumbersome means of achieving the same effect.

340. Durfee v. Duke, 375 U.S. 106, 115-16 (1963); SCOLES & HAY, *supra* note 338, § 24.10. *But cf.* Fall v. Eastin, 215 U.S. 1, 11-12 (1909) (holding that the law of the situs state determined the applicability of an out-of-state judgment as against a third party).

341. U.S. CONST. art. IV, § 1; *see also* Magnolia Petroleum Co. v. Hunt, 320 U.S. 430, 439 (1943) (explaining that the clear purpose of the Clause is to establish that litigation pursued to judgment in one state is given nationwide application).

342. Act of June 25, 1948, ch. 646, 62 Stat. 958 (codified as amended at 28 U.S.C. § 1963 (1988)); *see* Brainerd Currie, *Full Faith and Credit, Chiefly to Judgments: A Role for Congress*, 1964 SUP. CT. REV. 89 (suggesting that Congress should enact declarations of national policy on recognition of sister state judgments to solve implementation problems with the Full Faith and Credit Clause).

343. SCOLES & HAY, *supra* note 338, §§ 10.3, 10.6. Interstate jurisdictional issues frequently arise in the domestic relations context, where state courts are faced with the issue of how to coordinate local litigation with similar litigation filed by an estranged or former spouse in another state. *See, e.g.*, Brown v. Brown, 387 A.2d 1051, 1054-55 (R.I. 1978) ("[A] court should not, as a general rule, exercise its conceded power to enjoin a foreign divorce proceeding if the spouse sought to be enjoined is a bona fide domiciliary of the foreign jurisdiction.").

over federal matters since the Supremacy Clause effectively bars a state court from interfering with a proceeding initiated in federal court.[344]

Because corporations frequently are embroiled in litigation in a variety of locations at the time they file for bankruptcy relief, the question whether a state court could influence nonforum litigation is an important one. If a state court could not halt or otherwise coordinate out-of-state and federal litigation with the corporation's bankruptcy case, its ability to facilitate an effective resolution to the problems of a financially troubled debtor would be seriously impaired.

As with the court's abilities to resolve entitlements in out-of-state land, the apparent dilemma could be addressed in several ways. The uniform laws process could be used, for instance, to coordinate an agreement among the states to suspend ongoing litigation in the event that one of the parties files a bankruptcy petition in another state.[345] Another approach might be for Congress to enact a federal provision on this issue. Congress could implement a federal stay provision comparable to the automatic stay currently in place under the Bankruptcy Code[346]—a provision providing that the filing of a bankruptcy petition in a state court operates as a stay on the commencement or continuation of any litigation against the debtor corporation.[347]

344. U.S. CONST. art. VI; General Atomic Co. v. Felter, 434 U.S. 12, 17 (1977). Another, somewhat related, issue arising from the interaction between a state bankruptcy regime and federal law is the possibility that preemption problems might interfere with the ability of the states to regulate corporate bankruptcy effectively. In the insurance context, Congress has addressed this problem by enacting an anti-preemption provision, which gives states free reign to regulate the "business of insurance" without interference from potentially conflicting federal laws. 15 U.S.C. § 1012 (1988); *see* U.S. Dep't of the Treasury v. Fabe, 113 S. Ct. 2202, 2209-10 (1993) (upholding those parts of the priority scheme in Ohio's insurance insolvency statute that could be seen as regulating the "business of insurance" despite its conflict with a federal priority provision). This approach would be equally effective for corporate bankruptcy.

345. This approach has been employed with striking effectiveness in the domestic relations context. Nearly every state has enacted the Uniform Child Custody Jurisdiction Act in an effort to address an analogous difficulty—the filing of the same child support action in multiple states. *See* Ribstein & Kobayashi, *supra* note 176, at 29 (finding that the Uniform Child Custody Jurisdiction Act has been enacted by 52 states and territories). This statute requires a state court to postpone its exercise of jurisdiction over a child custody matter if the matter is also pending in another state until the court coordinates with the other state to determine the most appropriate venue. UNIF. CHILD CUSTODY JURISDICTION ACT § 6, 9 U.L.A. 123, 219-20 (1968). As Ribstein and Kobayashi point out, coordinating the states' approach to an issue is a function that the uniform laws process can perform well because a uniform law can serve as an effective focal point for interstate accord. Ribstein & Kobayashi, *supra* note 176, at 29.

346. *See* 11 U.S.C. § 362 (1988).

347. The concern here, as with a federal law governing the filing of claims, *see supra* notes 310-11, is that a federal stay provision might significantly affect the substantive contours of state bankruptcy law. From this perspective, an interstate accord might be a better solution than a federal stay law.

VI. Conclusion

I have attempted to show in this Article that the federal corporate bankruptcy framework now in place is not at all an inevitable one. For most of the nineteenth century, lawmakers vigorously contested the issue whether Congress should or even could pass federal bankruptcy legislation that extended to corporations. Not until the end of the century was the issue sufficiently settled that Congress could include corporate bankruptcy in a national bankruptcy act. Nor have the consequences of federalizing corporate bankruptcy been entirely happy ones. The creation of an artificial separation between state corporation law and federal corporate bankruptcy has led to vestigialization problems that have undermined both areas of the law.

In recent years, it has become apparent to most observers that Chapter 11 is deeply flawed. This Article suggests that the corporation law/corporate bankruptcy split is a contributing factor to the problems that commentators have observed. The best way to address this problem and to reform corporate bankruptcy in general would be to return control over corporate bankruptcy to the states. Not only would such a proposal eliminate the vestigializing effects of the current separation, but states almost certainly would enact better general corporation laws than they currently have in place and a better corporate bankruptcy regime than Congress has developed.

My analysis does not suggest that Congress should get out of the corporate bankruptcy business altogether. Rather, the proposal can be seen as calling for two kinds of federal rules. The first are essentially enabling rules—federal provisions whose purpose is simply to eliminate some of the obstacles to state regulation of corporate bankruptcy. Thus, for example, Congress should enact a choice-of-law provision requiring that courts look to the bankruptcy regime of a corporation's state of incorporation. Furthermore, Congress could minimize interstate friction by requiring that states recognize property judgments by a sister state's court in a bankruptcy case.

Second, and more substantively, Congress should regulate those areas of corporate bankruptcy in which the incentives of state lawmakers appear to be suspect. Given the limitations of federal lawmaking, Congress should only intervene to the extent it is particularly clear that Congress will regulate more effectively. Of the areas we considered, disclosure requirements and a provision counteracting forum shopping (perhaps included in the choice-of-law provision mentioned above) were the only contexts where the arguments for federal regulation were relatively clear.

Shifting corporate bankruptcy to the states is an admittedly dramatic step, however promising it appears in the abstract. The greatest obstacle may, in the end, be a practical one: Could such a proposal ever be passed?

Is it plausible that Congress would relinquish much of its control over corporate bankruptcy? From an interest-group perspective, one can easily imagine the sources of resistance. Bankruptcy judges and bankruptcy lawyers, for instance, both comprise concentrated groups, have an enormous stake in the existing regime, and would be extremely effective lobbyists. By contrast, many of the most obvious beneficiaries of the proposal are more diffuse. Moreover, Congress does not often cede authority back to the states once it has federalized an area of the law.

On the other hand, as noted earlier, states already control the liquidation and rehabilitation of insurance companies.[348] Given states' historical preeminence in regulating corporations, it is at least conceivable that the political climate might at some point generate support for shifting corporate bankruptcy authority back to the states.[349] Even before—or in the absence of—congressional action, the analysis has useful implications for corporation law and corporate bankruptcy. This Article suggests that lawmakers and bankruptcy courts should focus much more closely on the vestigialization caused by the federalization of corporate bankruptcy. More generally, it also suggests the need to talk once again about the institutional issues of why Congress is the primary regulator of corporate bankruptcy and to what extent it should retain that role.

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348. *See supra* notes 69, 105 and accompanying text.

349. It is also interesting to note that, while European commentators and lawmakers have debated whether uniform, Europe-wide rules are necessary in various corporation law contexts, no one seems to have suggested that Europe needs a unified bankruptcy regime of the sort we currently have in the United States. *See generally* David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L L.J. 423 (1991) (advancing a theory of when uniform, mandatory rules are appropriate); Conard, *supra* note 221 (describing the directives designed to "harmonize" European Community corporation law).

Appendix A: Nineteenth-Century Bankruptcy Laws

Characteristic	Bankruptcy Act of: 1800	1841	1867	1898
Scope	merchants only	any natural person	any natural person	any natural person
Corporate Bankruptcy	no	no	yes[a]	yes
Voluntary/ Involuntary	involuntary bankruptcy only	both[b]	both	both[c]
Preferences Regulated	no	yes (must show intent)	yes (presumption of intent)	yes (no intent requirement)
Exemptions	federal only	federal only	federal, supplemented by state	any available state exemptions

[a] Composition/reorganization was first added in 1874.
[b] Involuntary bankruptcy was limited to merchants only.
[c] Voluntary corporate bankruptcy was added in 1910 for all corporations except municipal, railroad, banking, and insurance corporations.

APPENDIX B: STATE PREFERENCE REGULATION

State	General Preference Law		Fraud Law Passed	Bank Preference Law		Insurance Preference Law	
	Passed	Date[a]		Passed	Date[a]	Passed	Date[a]
Alabama	no		UFTA	no		yes	1971
Alaska	no		yes	yes	1951	yes	1990
Arizona	no		UFTA	yes	1991	yes	1954
Arkansas	no		UFTA	yes	1921	yes	1959
California	yes	1992	UFTA	no		yes	1935
Colorado	yes	1897	UFTA	no		yes	1992
Connecticut	no		UFTA	yes	1991	yes	1991
Delaware	yes	1953	no	no		yes	1953
Florida	no		UFTA	yes	1992	yes	1969
Georgia	yes[b]	1984	no	no		yes	1992
Hawaii	no		UFTA	yes	1931	yes	1987
Idaho	no		UFTA	no		yes	1981
Illinois	no		UFTA	no		yes	1992
Indiana	yes	1982	no	yes	1933	yes	1993
Iowa	yes	1939	no	no		yes	1984
Kansas	no		no	no		yes	1991
Kentucky	yes[c]	1910	no	yes	1984	yes	1970
Louisiana	no		no	yes	1990	yes	1993
Maine	no		UFTA	no		yes	1991
Maryland	yes	1985	UFCA	no		yes	1963
Massachusetts	no		UFCA	no		no	
Michigan	no		UFCA	yes	1969	yes	1989
Minnesota	no		UFTA	no		yes	1969
Mississippi	no		no	yes	1969	yes	1991
Missouri	yes	1939	no	yes	1939	yes	1991
Montana	yes	1989	UFTA	no		yes	1979

[a] The date listed is the date of the most recent amendment.
[b] This statute is primarily a fraudulent conveyance provision.
[c] This statute is not limited to assignment or receivership context.

APPENDIX B (continued)

State	General Preference Law		Fraud Law Passed	Bank Preference Law		Insurance Preference Law	
	Passed	Date[a]		Passed	Date[a]	Passed	Date[a]
Nebraska	no		UFTA	yes	1933	yes	1989
Nevada	no		UFTA	yes	1971	yes	1971
New Hampshire	yes	1885	UFTA	no		yes	1969
New Jersey	yes	1928	UFTA	no		yes	1992
New Mexico	no		UFTA	yes	1991	yes	1993
New York	yes	1950	UFCA	no		yes	1989
North Carolina	yes	1909	yes	no		yes	1989
North Dakota	no		UFTA	no		yes	1993
Ohio	yes[c]	1953	UFTA	no		yes	1983
Oklahoma	yes	1910	UFTA	yes	1993	no	
Oregon	no		UFTA	yes	1973	yes	1967
Pennsylvania	yes	1901	UFCA	no		yes	1977
Rhode Island	no		UFTA	no		yes	1993
South Carolina	yes	1962	yes	no		yes	1982
South Dakota	yes	1969	UFTA	no		yes	1989
Tennessee	yes	1881	no	no		yes	1991
Texas	no		UFTA	yes	1943	yes	1955
Utah	no		UFTA	no		yes	1992
Vermont	no		no	no		yes	1991
Virginia	no		no	no		yes	1986
Washington	yes	1959	UFTA	yes	1955	yes	1947
West Virginia	no		UFTA	no		yes	1957
Wisconsin	yes	1969	UFTA	no		yes	1979
Wyoming	no		UFCA	yes	1977	yes	1983
TOTALS	YES 22		YES 38	YES 20		YES 48	
	NO 28		NO 12	NO 30		NO 2	

[a] The date listed is the date of the most recent amendment.

[b] This statute is primarily a fraudulent conveyance provision.

[c] This statute is not limited to assignment or receivership context.